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Giving the Average Investor the Keys to the Kingdom: How the Federal Securities Laws Facilitate Wealth Inequality

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GIVING THE AVERAGE INVESTOR THE KEYS TO THE KINGDOM: HOW THE FEDERAL SECURITIES LAWS FACILITATE WEALTH

INEQUALITY

Kevin G. Bender

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Abstract

Wealth inequality is one of the most pressing issues facing America today. Currently, the top ten percent of American households control over 84 percent of all American wealth, a proportion that has increased over 300 percent since 1986. While this issue continues to generate intense scrutiny from both sides of the political aisle, the role the federal securities laws play in facilitating wealth inequality goes largely unnoticed. In their present form, the Securities Act of 1933 and the Investment Company Act of 1940

contain exemptions to their registration and disclosure requirements that apply only to private placements—securities offerings and investment funds not offered for sale on a public securities marketplace. In the interest of investor protection, the Securities Act and the Investment Company Act prevent all but the extremely wealthy from investing in these private placements. Over the past two decades, wealthy investors comprising no more than the top ten percent of all Americans have been able to use the advantages of private placements to accumulate investment returns denied to the average middle class investor. This Note will outline how the exclusive private placement kingdom has contributed to wealth inequality in America and why the time has come to give the average investor the keys to this kingdom.

I. INTRODUCTION

In his 2015 State of the Union address, President Barack Obama declared that wealth inequality is one of the greatest challenges facing the United States today.¹ The President challenged Americans to confront the issue, declaring, “Will we accept an economy where only a few of us do spectacularly well?”² Republican presidential contenders such as Jeb Bush have also joined the chorus of commentators concerned about income inequality.³ While discussions of wealth inequality frequently deal explicitly with the ability of the very rich to easily accumulate greater wealth through capital appreciation—particularly returns on investment securities—the role that federal securities regulation plays in facilitating this outcome receives relatively little attention.⁴

Preventing excessive wealth disparity is not a stated objective of the U.S. securities laws.⁵ The U.S. Securities and

¹ Barack Obama, President of the United States, State of the Union (Jan. 20, 2015) (transcript available at <http://perma.cc/9BVX-E22Q>).

² *Id.*

³ Brendan Nyhan, *Why Republicans Are Suddenly Talking About Economic Inequality*, New York Times (Feb. 13, 2015), <http://perma.cc/4DKZ-NK8Q>.

⁴ See generally, e.g., THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (Harvard University Press 2013); CHARLES E. HURST, *SOCIAL INEQUALITY: FORMS, CAUSES, AND CONSEQUENCES* (Pearson Education 2007).

⁵ See Jasmin Sethi, *Another Role for Securities Regulation: Expanding Investor Opportunity*, 16 FORDHAM J. CORP. & FIN. L. 783, 796 (2011) (“[S]ecurities regulation can . . . be justified on a number of grounds, but historically, expanding

Exchange Commission (“SEC”), the federal agency tasked with implementing the federal securities laws, states that its mission is “to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.”⁶ Although wealth disparity appears nowhere in the identified intentions of the securities laws, the current structure of the laws nevertheless facilitates the concentration of wealth in the hands of the wealthiest ten percent of Americans.

This Note will argue that the federal securities laws facilitate wealth inequality by denying average middle class investors the ability to participate in the private placement (or “alternative investment”⁷) securities market.⁸ The private placement market comprises all securities offerings exempt from the registration and disclosure requirements of the Securities Act of 1933 (“Securities Act”) and the Investment Company Act of 1940 (“Investment Company Act”).⁹ These offerings of securities are usually referred to as private placements because they are not available for purchase on a public securities market, such as a public stock exchange.

Working from the assumption that private placements are inherently riskier than public securities such as stocks, bonds, and

opportunities for wealth accumulation across sectors of the population has not been a justification that has been given credence.”).

⁶ U.S. SECURITIES AND EXCHANGE COMMISSION, <http://perma.cc/45AG-K6H3> (last visited Oct. 13, 2014).

⁷ “Alternative Investment” is a largely undefined term often used to refer to any investment other than stocks, bonds, mutual funds, or cash, but it typically refers to investments in private investment funds. While the SEC does refer to direct stock purchases in private companies as “alternative investments,” *see, e.g., Investor Alert: Self-Directed IRAs and the Risk of Fraud*, INVESTOR.GOV, <http://perma.cc/LN72-C493> (last visited Jan. 27, 2015), the more common label for any non-public securities offering is a “private placement,” *see, e.g., Private Placements Under Regulation D*, INVESTOR.GOV, <http://perma.cc/Z2WN-MSFQ> (last visited Jan. 27, 2015). To avoid confusion, this Note will refer to both private investment funds and direct stock purchases in private companies collectively as “private placements.”

⁸ While this Note addresses wealth inequality, the argument deals primarily with how the already wealthy accumulate even greater wealth relative to the middle class. The reasons for wealth inequality at the other end of the spectrum—why the already poor continue to fall further behind the middle class—are outside the scope of this Note.

⁹ Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a- to -aa (2012)) [hereinafter Securities Act]; Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80a-1 to -64 (2012)) [hereinafter Investment Company Act].

mutual funds,¹⁰ the federal securities laws permit only certain high net worth and high-income individuals to invest in private placements.¹¹ The common justification for this restriction is that wealth—as measured by net worth and net income—serves as the most practicable proxy for the ability to “fend for oneself in a transaction”¹² without the investor protections afforded by the Securities Act and the Investment Company Act.¹³ Scholars have frequently noted, however, that this objective standard, intended for administrative ease, may be both under protective of wealthy investors and over protective of non-wealthy investors.¹⁴ The current federal securities laws presume, somewhat paternalistically, that while the average middle class investor can “risk his shirt,”¹⁵ on the public stock markets, only the wealthy investor can risk his shirt in a private placement. Nevertheless, “U.S. securities regulations award special investment privileges to the already affluent, resulting in a legal system that makes it even easier for them to amass wealth.”¹⁶

The overriding approach to mitigating this outcome has been to suggest alternatives to net worth and net income that more closely

¹⁰ See, e.g., Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Release No. 8766 at 8 (Dec. 27, 2006), [hereinafter SEC Release 8766].

¹¹ See *infra* Part II.

¹² Sec. and Exch. Comm’n. v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

¹³ See SEC Release 8766, *supra* note 10, at 7 (“We adopted the \$1,000,000 net worth and \$200,000 income standards in 1982 based on our view that these tests would provide appropriate and objective standards to meet our goal of ensuring that such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one.”).

¹⁴ See, e.g., Greg Oguss, Note, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?* 107 NW. U. L. REV. 285, 291 (2012). Some articles have drawn attention to the fact that Paris Hilton is an accredited investor who may participate in private placements while an investment banker who recently graduated with an M.B.A. from Harvard Business School may not have the requisite net worth or income to make those same investments. Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC’s “Accredited Investor” Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733 (2009). But see Oguss, *supra* at 294, noting that wealthy investors can “purchase sophistication” by hiring financial advisers to make investment decisions on their behalf. This, however, does not obviate the basic truth that even the most sophisticated investor is not immune against losses resulting from fraud and deception, regardless whether their investments are private or public. See Felicia Smith, *Madoff Ponzi Scheme Exposes “The Myth of the Sophisticated Investor,”* 40. U. BALT. L. REV. 215 (2010).

¹⁵ Usha Rodrigues, *Securities Law’s Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3428-29 (2013).

¹⁶ So-Yeon Lee, *Why the ‘Accredited Investor’ Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 987 (2012).

approximate the sophistication needed to fend for oneself.¹⁷ Most of these approaches concentrate exclusively on the over or under inclusive nature of the current securities laws, not the implicit inequity they create vis-à-vis middle class Americans. Little serious discussion exists about whether we *ought to have* an independent realm of private placements accessible only to wealthy investors. SEC attorney Jasmin Sethi, an advocate for expanding investor opportunity, sums-up this moral dilemma best:

Access to financial markets, like access to education, employment, public accommodations, and a host of other areas, is significant in promoting opportunity. In the case of financial markets, the opportunity at stake is the opportunity to create and accumulate wealth. The adage, “it takes money to make money,” or, in other words, the assumption that wealth is required to create more wealth, embodies the idea that wealth results from the taking of large risks and that the wealthy are more likely and better able to bear such risks. While these assumptions do have some truth to them, a societal problem arises when government action perpetuates the superior opportunities of the wealthy to become wealthier. Inequity in the opportunity to grow wealth should not be facilitated by the government any more than inequities in opportunities for education, employment, accommodations, and the like.¹⁸

That is not to say that the private placement market ought not to exist. On the contrary, the financial industry needs a certain amount of flexibility in order to develop novel investment products able to increase aggregate wealth (or in economic terms, total surplus).¹⁹ At the same time, the inequity of excluding the private market to average investors is inexcusable. In the aftermath of the “Great Recession,” increasing the investment opportunities available to the average American may prove critical. Savings rates among the middle class have declined, the 2008 financial crisis caused up to a 75 percent drop in some retirement savings accounts, and the value

¹⁷ See *infra* sources cited and text accompanying notes 258-262.

¹⁸ Sethi, *supra* note 5, at 797-98.

¹⁹ See, e.g., *Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcomm. on Telecomm. & Fin. of the H. Comm. on Commerce*, 104th Cong. 4 (1995).

of primary residences—a traditional source of investment wealth for middle class Americans—has declined precipitously.²⁰

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) requires that the SEC revisit one of the most ubiquitous features of the private offerings regime, the Accredited Investor definition with respect to natural persons,²¹ ostensibly with the objective of further limiting who is eligible to invest in private placements.²² This mandated review marks a turning point. Will Congress and the SEC embrace an open, egalitarian investment marketplace or one that benefits primarily the already wealthy? Although preventing runaway wealth disparity is not a stated objective of the U.S. securities laws,²³ the time has come for Congress and the SEC to adopt a more egalitarian approach to private placements. The time has come to give the average investor the keys to the kingdom.

Through both a notional discussion of the advantages to private placements and an empirical study of investment returns, this Note will argue that the current legal structure of the private placement exemptions has contributed to the growth in wealth inequality in America. Part II will outline the current legal framework of private placements. Part III will then discuss the advantages private placements sometimes possess over public markets. Using two case studies in particular—the technology bubble of the 1990’s and the financial crisis of 2008—Part IV will empirically demonstrate that the advantages of private placements allow their wealthy investors to preserve capital and generate higher long-term returns. Finally, Part V will discuss many of the proposals for expanding investor access to the private placement market.

II. PRIVATE PLACEMENTS AND WHO CAN INVEST

The two principal components of the private placement market are direct investments in privately owned companies and investments in private investment funds. There are three major kinds of private investment funds: hedge funds, private equity funds, and

²⁰ Lee, *supra* note 16, at 1008-11.

²¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, 124 Stat. 1376, § 413 (2010).

²² Lee, *supra* note 16, at 990-91 (“the dominant narrative offered as an explanation for the Great Recession of 2008 [is] that investors took risks that they did not understand”).

²³ Sethi, *supra* note 5, at 796.

venture capital funds. The term “hedge fund” has no official definition.²⁴ The defining characteristic of hedge funds is their exemption from the Investment Company Act,²⁵ a statute that limits the positional strategies of registered investment funds (such as mutual funds) and their ability to use leverage.²⁶ Exemption from the Investment Company Act allows hedge funds to use unique trading strategies in the expectation of generating returns in both bull and bear markets.²⁷ Unlike hedge funds, which focus primarily (although not exclusively) on short-term gains, private equity funds seek long-term gains by acquiring portfolio company securities and liquidating their positions at the end of a specified term, usually five to ten years.²⁸ Venture capital funds are a subset of private equity funds that specialize in early-stage companies.²⁹ Unlike a traditional private equity fund, a venture capital fund typically seeks to exit its portfolio company investments once they reach a target price and not at the end of a specified term.³⁰ A venture fund usually achieves exit of its investments either through an initial public offering (“IPO”) or by selling the portfolio company to a strategic buyer.³¹

Sales and purchases of securities in private companies comprise the other major component of the private placement market. Most of this investment occurs when an issuer, a business entity seeking to raise capital by selling its own securities, elects to conduct a private placement in lieu of an IPO. Many issuers, particularly emerging companies, prefer to raise capital through private placements because of the significant cost savings.³² This has

²⁴ SEC. & EXCH. COMM’N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, 3 (2003) (available at <http://perma.cc/SAG2-2RG5>); see also Matthew Goldstein, *A Secret Society: Hedge Funds and Their Mysterious Success*, 6 J. INT’L BUS. & L. 111, 114 (2007).

²⁵ SEC Staff Report, *supra* note 24, at 3.

²⁶ *Id.* at 6.

²⁷ Goldstein, *supra* note 24, at 114. A “long” position refers to the traditional strategy of expecting the value of an investment to increase over time. On the contrary, a “short” position assumes that an investment will lose value. The ability of hedge funds to take both positions concurrently is how they derive their name; they are able to “hedge” the risk of long positions by taking short positions. *Id.*

²⁸ SEC Staff Report, *supra* note 24, at 7-8.

²⁹ *Id.* at 8.

³⁰ *Id.*

³¹ Rodrigues, *supra* note 15, at 3406-07.

³² By avoiding an IPO for as long as possible, an issuer can escape the costs of preparing a prospectus and a registration statement, avoid the delay costs associated with the SEC comment process, preserve the confidentiality of company information, evade compliance with the Sarbanes-Oxley Act, and avoid obtaining a

resulted in the growth of the private placement market at the expense of IPOs, particularly for smaller companies.³³ This trend may mean fewer and fewer options for average investors relative to the size of the entire securities market.³⁴

The unifying characteristic of all private placements is that they are exempt from the registration requirements of the Securities Act.³⁵ In addition, all private investment funds are also exempt from the provisions of the Investment Company Act.³⁶ In order to achieve exemption from the Securities Act and the Investment Company Act, a securities offering or investment fund must meet an enumerated registration exemption.³⁷ The most common exemptions are the private offering exemptions,³⁸ encompassing offerings of securities not considered part of a “public offering.”³⁹ These exemptions include Securities Act section 4(a)(2), Securities Act section 4(a)(5), Regulation D, Investment Company Act section 3(a)(1), and Investment Company Act section 3(a)(7). All the private offering exemptions share one significant requirement: they restrict investment participation to specific high income and high net-worth individuals through, in the case of the Securities Act, the accredited investor standard, or, in the case of the Investment Company Act, the even more restrictive qualified purchaser standard.

A. Securities Act Section 4(a)(2), Regulation D, and the Accredited Investor

In order to provide investors with adequate information with which to make an informed investment decision,⁴⁰ the Securities Act requires any issuer seeking to sell securities to either register the

credit rating on public debt. See Lee, *supra* note 16, at 1005-06 (citing MELANIE L. FEIN, SECURITIES OF ACTIVITIES BANKS § 10.01 (4th ed. 2011)).

³³ See, e.g., Rodrigues, *supra* note 15, at 3407 (citing Douglas J. Leary, *M&A Landscape in 2013: Whither the Bottom?*, in MERGERS AND ACQUISITIONS LAW 2013: TOP LAWYERS ON TRENDS AND KEY STRATEGIES FOR THE UPCOMING YEAR 55 (2013), available at 2013 WL 574804, at *4).

³⁴ See Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings, 78 Fed. Reg. 44730, 44755 [hereinafter “Disqualification of Bad Actors”]; Lee, *supra* note 16, at 1006-06.

³⁵ SEC Staff Report, *supra* note 24, at 5-8.

³⁶ *Id.*

³⁷ See *infra* Part II.A. and Part II.B.

³⁸ See Disqualification of Bad Actors, *supra* note 34, at 44753-54.

³⁹ Securities Act § 4(a)(2), (5), 15 U.S.C. § 77a- to -aa (2012); Investment Company Act § 3(c)(1), (7), 15 U.S.C. § 80a-1 to -64 (2012).

⁴⁰ 77 CONG. REC. 2913 (May 5, 1933).

securities offering with the SEC or qualify for an exemption from registration.⁴¹ The current private offering exemption originated in what was originally section 4(1) of the Securities Act, which exempted any “transactions by an not involving any public offering.”⁴² It is unclear precisely what transactions the drafters of the Securities Act intended to exempt through Section 4(1).⁴³ In the seminal case *Securities and Exchange Commission v. Ralston Purina Company*, the Supreme Court promulgated what remain the twin aims of the private offering exemption—access to the information normally provided in a registration statement and the ability to fend for oneself in a transaction.⁴⁴ The SEC has always understood the *Ralston Purina* decision to mean that investors in offerings exempt under section 4(1)—presently section 4(a)(2)—had to have “sufficient knowledge and experience in financial and business matters to . . . evaluate the merits of the prospective investment or . . . [be] able to bear the economic risk of the investment.”⁴⁵

Originally, the SEC determined whether a securities purchaser met this standard using a subjective analysis.⁴⁶ This procedure changed when Congress enacted the Small Business Investment Incentive Act of 1980, which added section 4(6)—now section 4(a)(5)—to the Securities Act.⁴⁷ Section 4(a)(5) created a new private offering exemption available exclusively to “accredited investors,”⁴⁸ but left it to the SEC to define who qualified as an accredited investor.⁴⁹ Congress directed the SEC to take into account factors including “financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management.”⁵⁰ To implement section 4(a)(5) and define who qualified as an accredited investor, the SEC in 1981 adopted a

⁴¹ Securities Act §§ 5-7.

⁴² *Id.* § 4(a)(2).

⁴³ *See* Sec. and Exch. Comm’n. v. Ralston Purina Co., 346 U.S. 119, 122 (1953) (“The Securities Act nowhere defines the scope of § 4(1)’s private offering exemption. Nor is the legislative history of much help in staking out its boundaries.”).

⁴⁴ *Id.* at 124-26.

⁴⁵ SEC Release 8766, *supra* note 10, at 7.

⁴⁶ *Id.*

⁴⁷ Small Business Investment Incentive Act of 1980, Pub. L. No. 96-447, 94 Stat. 2294 (1980).

⁴⁸ *Id.* § 602 (codified at 15 U.S.C. § 77d(5)).

⁴⁹ *Id.* § 603 (codified at 15 U.S.C. § 77b(15)(ii)).

⁵⁰ *Id.*

comprehensive private offering exemption called Regulation D, presently comprising Securities Act Rules 500 to 506.⁵¹

The foundation of Regulation D is the accredited investor standard, defined in SEC Rule 501.⁵² Along with certain institutional investors, Rule 501 defines as an accredited investor “any natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000” excluding the value of the person’s primary residence,⁵³ or “any natural person who had an individual income in excess of \$200,000 . . . or joint income with that person’s spouse in excess of \$300,000.”⁵⁴ The SEC estimates that, as of 2010, approximately 8.7 million U.S. households qualify as accredited investors based on the \$1 million net worth standard, or approximately 7.4 percent of U.S. investors.⁵⁵ Based on 2010 income tax returns from the Internal Revenue Service, only about one percent of single taxpayers have an annual income of over \$200,000, and only about five percent of married taxpayers have a joint income in excess of \$300,000.⁵⁶

Rules 504, 505, and 506 outline the requirements for the Regulation D registration exemptions.⁵⁷ Under Rules 504 and 505, issuers must ensure their securities offerings are exempt under both federal securities law and state securities law.⁵⁸ Securities Act section 18, however, grants “covered securities” status and preempts state law for all securities sold under Rule 506.⁵⁹ Consequently, Rule

⁵¹ See Proposed Revision of Regulation C, Registration and Regulation 12B, Registration and Reporting, 46 Fed. Reg. 41971 (proposed Aug. 18, 1981) (to be codified at 17 C.F.R. pts. 201, 230 & 240).

⁵² 17 C.F.R. § 230.501.

⁵³ *Id.* § 230.501(a)(5).

⁵⁴ *Id.* § 230.501(a)(6).

⁵⁵ Disqualification of Bad Actors, *supra* note 34, at 44756.

⁵⁶ SOI TAX SATS – INDIVIDUAL STATISTICAL TABLES BY FILING STATUS, [www.irs.gov/uac/SOI_Tax-Stats---Individual-Statistical-Tables-by-Filing-Status\\$_grp1](http://www.irs.gov/uac/SOI_Tax-Stats---Individual-Statistical-Tables-by-Filing-Status$_grp1) (last visited Oct. 14, 2014).

⁵⁷ Rules 504 and 505 are exemptions under Securities Act section 4(a)(5) as opposed to 4(a)(2). Presently, Rule 504 exempts from registration sales of up to \$1 million of securities sold in a twelve-month period only to accredited investors or securities sold to accredited investors in reliance on state registration exemptions. Rule 505 exempts up to \$5 million of securities sold in a twelve-month period only to accredited investors and up to 35 non-accredited investors. 17 C.F.R. § 230.504-06.

⁵⁸ See *infra* sources cited note 62.

⁵⁹ Securities Act § 18(b)(4)(E). Technically, the provision exempts sales of securities relying on “Commission rules or regulations issued under section 4[a](2).” As the general 4(a)(2) exemption is not a Commission rule or regulation, and Rules 504 and 505 are issued under Securities Act section 4(a)(6), Securities Act section 18(b)(4)(E) only covers Rule 506.

506 provides the operative exemption for the vast majority of private placements conducted under Regulation D.⁶⁰ Rule 506 exempts unlimited securities sales to accredited investors and up to 35 non-accredited investors who demonstrate sophistication in business and financial matters.⁶¹ In 2013, Congress passed the Jumpstart Our Business Startups (JOBS) Act, which added Securities Act Section 4(b) and allowed the SEC to adopt Rule 506(c).⁶² The new provision removes the preexisting ban on general advertising that applied to Rule 506 (now referred to as Rule 506(b)), but it also requires that all Rule 506(c) offerings involve *exclusively* accredited investors.⁶³ Despite the fact that Rule 505, Rule 506(b), and the general 4(a)(2) exemptions all permit a small number of non-accredited investors, less than ten percent of Regulation D offerings involve non-accredited investors.⁶⁴ Consequently, the securities laws presently restrict virtually all private placements to accredited investors.

Based on the SEC's own estimates, in 2010 there were approximately \$1 trillion of registered securities offerings (public debt and public equity) and approximately \$1 trillion of exempt securities offerings.⁶⁵ These statistics reveal that, based on the net worth standard, approximately 92.6 percent of Americans do not have the ability to invest in half of the securities offered for sale each year.⁶⁶ Using the net income standard produces an even starker picture: about 95 percent of the investing public remains excluded from purchasing half the securities offered each year. Given the growth of private placements at the expense of IPOs,⁶⁷ the present situation will mean fewer investment options for middle class

⁶⁰ See Disqualification of Bad Actors, *supra* note 34, at 44756.

⁶¹ 17 C.F.R. § 230.506(b). The non-accredited investors must receive a private placement memorandum with similar requirements as a registration statement. 17 C.F.R. § 230.502(b).

⁶² Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at scattered sections of 15 U.S.C.).

⁶³ 17 C.F.R. § 230.506(c); *see also* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release 33-9415, 78 Fed. Reg. 44771 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239, 242) [hereinafter SEC Release 33-9415].

⁶⁴ SEC Release 33-9415, *supra* note 63. This is likely because Rule 502 requires that non-accredited investors in offers exempt under Regulation D receive a detailed private placement memorandum that mirrors a registration statement, thereby vitiating the advantage to issuers of avoiding Securities Act registration. 17 C.F.R. § 230.502(b).

⁶⁵ Disqualification of Bad Actors, *supra* note 34, at 44754.

⁶⁶ *Id.* at 44756.

⁶⁷ *Id.* at 44754; Lee, *supra* note 16, at 1006-06.

Americans and even greater capital appreciation opportunities for the already wealthy.

B. Investment Company Act Section 3(c)(7) and the Qualified Purchaser

In addition to qualifying for an exemption from Securities Act registration, private investment funds must also qualify for an exemption from the Investment Company Act, which requires that all investment companies register with the SEC and places limits on investment companies' activities.⁶⁸ The Investment Company Act, however, exempts from its definition of an investment company a number of entities.⁶⁹ The original private fund exception, section 3(c)(1), excludes from the definition of investment company funds owned by not more than 100 beneficial owners and not publicly offered.⁷⁰ Originally, the intent of section 3(c)(1) was to exclude investment companies so small that federal regulation appeared unnecessary,⁷¹ but the 100 beneficial owner cap left this provision with limited utility.⁷²

With the intent of promoting regulatory simplicity, easing compliance costs for investment companies, and encouraging novel investment products,⁷³ the National Securities Markets Improvement Act of 1996 ("NSMIA") modified section 3(c)(1) and, much more significantly, added the section 3(c)(7) exemption.⁷⁴ Section 3(c)(7)

⁶⁸ Investment Company Act § 8.

⁶⁹ *Id.* § 3(b)-(c). Section 3(a) defines as an investment company any issuer of securities whose primary business (or intended future business) is investing, reinvesting, or trading in securities, whether on its own behalf or on the behalf of others. *Id.* § 3(a)(1)(A).

⁷⁰ *Id.* § 3(c)(1).

⁷¹ *Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcomm. on Telecomm. & Fin. of the H. Comm. on Commerce*, 104th Cong. 15 (1995) (statement of Barry P. Barbash, Director, Sec. & Exch. Comm'n. Div. of Inv. Mgmt.)[hereinafter NSMIA Hearings]. As the financial markets developed, this exception began to cover entities established for the sole purpose of investing in an emerging company, syndicated loan entities, or entities established solely to serve as acquisition vehicles. *Id.* at 17.

⁷² *Id.* at 15; see also Investment Company Act § 3(c)(1)(A). The Investment Company Act also contained a "look-through" provision, whereby if an entity owned 10 percent or more of the investment company, the shareholders of the entity were included as beneficial owners of the investment company. *Id.*

⁷³ NSMIA Hearings, *supra* note 71, at 4-5.

⁷⁴ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 209, 110 Stat. 3416, 3432-36, (1996) (codified at 15 U.S.C. § 80a-3(c)(7)).

exempts entities that would otherwise meet the definition of an investment company if such companies are owned entirely by “qualified purchasers.”⁷⁵ Qualified purchasers, as defined in section 2(a)(51), are certain institutions and natural persons that own more than \$5 million in investments.⁷⁶ As with the definition of accredited investor, the qualified purchaser definition sought to cover “financially sophisticated investors . . . in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act’s protections.”⁷⁷ The drafters of NSMIA conceded from the very beginning that the section 3(c)(7) exemption would cause the considerable growth of so-called “hedge funds” and other private investment funds, broadening significantly the size of the private placement market.⁷⁸ Section 3(c)(7), which imposed no cap on the number of beneficial owners, ultimately made the section 3(c)(1) exemption irrelevant.⁷⁹

The exemptions in the Investment Company Act and the Securities Act inherently work in tandem. Any investment company must sell its own securities in order to raise capital and therefore it must either register such offering or meet an exemption from the Securities Act. As section 3(c)(7) contemplates securities not part of any “public offering,”⁸⁰ the prospective purchasers of interests in private funds must meet the qualifications of an accredited investor under Regulation D as well as the qualifications of a qualified purchaser.⁸¹

⁷⁵ Investment Company Act § 3(c)(7).

⁷⁶ *Id.* § 2(a)(51)(A). Investment Company Act Rule 2a51-1 defines “investments” to include securities, equity in private companies owned and operated by the investor, equity in real estate other than a primary residence, commodity interests, derivatives and other financial contracts, certificate deposits and similar instruments, and the cash value of certain insurance policies. 17 C.F.R. § 270.2a51-1 (2014).

⁷⁷ NSMIA Hearings, *supra* note 71, at 16.

⁷⁸ *Id.* at 15-18.

⁷⁹ See Justin Asbury Dillmore, Comment, *Leap Before You Look: The SEC’s Approach to Hedge Fund Regulation*, 32 OHIO N.U. L. REV. 169, 176 (2006) (citing Erik J. Greupner, Comment, *Hedge Funds Are Headed Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1561-62 (2003)).

⁸⁰ Investment Company Act § 3(c)(7).

⁸¹ See Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 3 (2006). Given that the qualified purchaser standard is much more stringent than the accredited investor standard, it is difficult to envision a scenario whereby a qualified purchaser would not also be an accredited investor.

C. Secondary Market Transfers and Rule 144

The Securities Act's requirements apply not only to the initial offer and sale of securities but also to the subsequent resale of securities on secondary markets. Consequently, the resale limitations imposed by Securities Act Rule 502(d) cover all private placements.⁸² Rule 502(d) states that the owner of securities acquired in any private offering cannot resell such securities without either registering the resale or meeting the requirements of an exemption from registration.⁸³ The most common exemption for a resale of restricted securities is section 4(a)(1) involving "transactions by any person other than an issuer, underwriter, or dealer."⁸⁴

Securities Act Rule 144 provides a safe harbor for the definition of "underwriter," consequently providing an exemption from registration for resale of restricted securities.⁸⁵ So long as the original issuer is still a private issuer and not subject to the ongoing reporting requirements of the Securities Exchange Act of 1934, a minimum of one year must lapse after the purchase of the security prior to resale.⁸⁶ If the security is of a private issuer that has subsequently become a public company or become subject to the reporting requirements of the Securities Exchange Act of 1934, then Rule 144 reduces the minimum holding period to only six months.⁸⁷ The most significant consequence of Rule 144 is illiquidity; investors in private placements cannot sell their interests without first satisfying the minimum holding period.

III. THE ADVANTAGE OF PRIVATE PLACEMENTS

The provisions of the Securities Act and the Investment Company Act that restrict private placements to qualified purchasers and accredited investors not only inhibit investor choice, they also affect the potential total returns investors are capable of earning.

⁸² 17 C.F.R. § 230.502(d) (2014).

⁸³ *Id.*

⁸⁴ Securities Act § 4(a)(1), 15 U.S.C. § 77a- to -aa (2012).

⁸⁵ 17 C.F.R. § 230.144.

⁸⁶ 17 C.F.R. § 230.144(d)(1)(ii). If the purchaser seeking to resell a security is an affiliate of the issuer, current public information about the issuer must be available. 17 C.F.R. § 230.144(b)(2),(c). The rule also restricts the number of securities an affiliate can sell at any time. 17 C.F.R. § 230.144(b)(2),(e).

⁸⁷ 17 C.F.R. § 230.144(d)(1)(i). Restrictions on sales by affiliates still apply. 17 C.F.R. § 230.144(b)(2), (c), (e).

Even while long-term returns from most private placements ultimately remain lower than the potential returns on public securities,⁸⁸ private placements have certain advantages over public securities that result in either greater stability or potentially spectacular returns. The significant advantages of many private investment products include isolation from market risk, price-advantageous early entry into emerging companies, unique trading strategies that preserve principal, and the ability to interact with extraordinary market events. This Part will discuss the advantages of both forms of private placements denied to average investors—direct investments in private companies and investments in private investment funds.

A. Direct Investments in Private Companies

The analysis that follows will focus primarily on one form of exempt offering the Securities Act seeks to restrict to wealthy investors: “angel” investments in emerging companies. Although this analysis will focus on the inherent advantages of angel investments, many of these same advantages would likewise apply to other direct private investments, including, for example, Rule 701 offerings,⁸⁹ or investments in established private companies.⁹⁰ This analysis will discuss two major advantages of angel investments: (1) investors may benefit through early investments in emerging companies that either subsequently go public or become targets in an acquisition; and (2) because private securities are not listed on a public securities exchange, they are isolated to a considerable degree from market risk.

⁸⁸ See Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 306 (2009).

⁸⁹ Securities Act Rule 701 is an exemption from the Securities Act for securities issued pursuant to employee compensation programs and is therefore a form of private investment not restricted to Accredited Investors. Employees able to participate in such offerings are able to take advantage of the numerous features that make these offerings advantageous despite not being among the elite Accredited Investors and Qualified Purchasers. Employees, however, can only purchase or receive the securities of their own employer, or their employer’s parent corporation, and thus the exception is extremely limited and provides few diversification options for investors. 17 C.F.R. § 230.701.

⁹⁰ For example, investors in American Express or Alibaba in the months prior to their respective IPOs would have received the same investment benefits as early angel investors in companies such as Twitter or Facebook. *See infra* sources cited and text accompanying notes 93-95.

Most investment in early stage companies comes through angel investments, relatively small investments made by individual accredited investors.⁹¹ Early entry by angel investors into emerging companies provides these investors the opportunity to earn multiples on their investment not generally possible with public securities. These returns are possible because the market itself values public securities and (absent insider trading) all market participants make investment decisions using the same information, whereas the market possesses little to no information about private securities. The lack of public information leads to imperfect pricing of private securities, often with a discount either for illiquidity⁹² or for issuer cost savings.⁹³ The often superficially low entry point into private securities only multiplies the potential returns investors enjoy upon ultimate liquidation of their position.

Law professor Usha Rodrigues uses the Facebook IPO as an example of this phenomenon, noting, “[s]ome accredited investors bought into Facebook early at remarkably low prices, ranging from \$1.11 to \$9.82 per share, and enjoyed tremendous returns when the IPO occurred . . .”⁹⁴ Even absent an IPO, angel investors can often enjoy similar returns through a control premium offered by a venture capitalist, a private equity fund, or a strategic buyer that subsequently acquires the issuer.⁹⁵ In either instance, angel investing presents the possibility to accredited investors of huge return multiples not available to average investors restricted to the public markets.

Angel investments, in addition to earning potentially spectacular return multiples, are less susceptible to price fluctuations because they are isolated from market risk. Houman Shadab, research fellow at the Mercatus Center at George Mason University and advocate for expanded investor access to private placements, states that there are two basic kinds of investment risk: idiosyncratic

⁹¹ Rodrigues, *supra* note 15, at 3397.

⁹² *Id.* at 3393 (“[A] vibrant secondary market increases the price that shares will fetch on the primary market; the possibility of resale increases the price of a product.”).

⁹³ Lee, *supra* note 16, at 1006.

⁹⁴ Rodrigues, *supra* note 15, at 3392. Facebook closed at \$38.23 the first day of public trading, representing a return of investment of 26 percent on the \$9.82 price and of 3,444 percent on the \$1.11 price. *Id.* at 3391-92. Rodrigues also notes that “the very last investors overpaid relative to the IPO price, with the final private auctions closing above \$40 per share.” *Id.* at 3392.

⁹⁵ *Id.* at 3398, 3406-07.

risk and market risk.⁹⁶ Idiosyncratic risk, the risk of a particular investment losing most or all of its value, arises out of the character of the particular investment.⁹⁷ This is the risk the federal securities laws are concerned about when limiting who can invest in private securities offerings.⁹⁸ Market risk, on the other hand, describes the possibility that the value of an investment will change based upon the conditions of the entire market.⁹⁹

All investments contain some degree of idiosyncratic risk. Most private placements, however, are immune to many forms of market risk while public securities are not.¹⁰⁰ The business fundamentals and long-term prospects of a public company may be favorable, but the stock price may nevertheless plummet during a market sell-off because the price will follow broader market trends. Owners of illiquid private securities, however, cannot readily sell their interests on a market.¹⁰¹ Consequently, public markets do not continually revalue private securities the way they do public stocks, isolating them from market risk.

Proponents of narrow private placement exemptions, however, often mention this illiquidity as a significant risk.¹⁰² Investors in private placements who need to convert their securities into cash may discover that they cannot sell their securities due to the restrictions of Rule 144,¹⁰³ may have to sell their securities at a substantial loss,¹⁰⁴ or find themselves without a market for the securities altogether. This predicament helps explain why the federal securities laws focus so heavily on wealth as a gateway for access to private placements. Wealthier investors can tie-up greater amounts of their capital in illiquid investments because they are likely to have sufficient liquid investments to meet unexpected cash requirements.¹⁰⁵ On the other hand, nothing prevents wealthy investors from committing an excessive percentage of their capital to illiquid investments and finding themselves in the same position as

⁹⁶ Shadab, *supra* note 88, at 265.

⁹⁷ *Id.*

⁹⁸ *See, e.g.*, SEC Release 8766, *supra* note 10, at 7; *see also* Sec. and Exch. Comm'n. v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

⁹⁹ Shadab, *supra* note 88, at 266.

¹⁰⁰ *Id.*

¹⁰¹ *See supra* Part II.C.

¹⁰² Rodrigues, *supra* note 15, at 3428; *see also* Lee, *supra* note 16, at 993.

¹⁰³ *See supra* Part II.C.; *see also* Rodrigues, *supra* note 15, at 3405.

¹⁰⁴ Lee, *supra* note 16, at 993.

¹⁰⁵ *Id.* at 993-95.

any other investor.¹⁰⁶ Likewise, an intelligent average investor could invest a proportionate amount of their capital in illiquid investments such that they could satisfy unexpected cash needs with other liquid investments.

In addition, emerging secondary markets for private securities like SecondMarket and SharesPost have partially resolved the illiquidity risks by providing a means for investors in private securities to find potential buyers.¹⁰⁷ With secondary markets for private securities, investors in private offerings have the opportunity to liquidate private securities, valued outside the vicissitudes of the public markets, in lieu of public equities. Right now, however, these secondary markets remain restricted to only accredited investors.¹⁰⁸ Consequently, during times of market stress, wealthy accredited investors besought with sudden cash needs possess the unique ability to sell private securities (potentially at a gain or more limited loss) while investors restricted to the public markets can only sell at a loss.

Even though angel investments benefit from lower market risk, they come with a high level of idiosyncratic risk. Illiquidity and the lack of market information only amplify this risk.¹⁰⁹ Approximately two-thirds of all angel investments ultimately lose most or all of their value.¹¹⁰ At the same time, these same features of angel investments—illiquidity and lack of market information—allow them to generate returns many times their original basis.¹¹¹ This interaction of risks and rewards results in an average aggregate return of approximately ten percent, assuming appropriate diversification among many angel investment options.¹¹² By way of comparison, the average return on the Standard & Poor's 500 index from 1980 to present was 13.06 percent and the return on bonds—often considered an important portfolio diversification tool for

¹⁰⁶ *Id.*

¹⁰⁷ Rodrigues, *supra* note 15, at 3402-06. The market exchanges undertake efforts to ensure that investors comply with Rule 144 and Regulation D.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 3428.

¹¹⁰ *Id.* at 3398 (citing Robert Wiltbank, At the Individual Level: Outlining Angel Investing in the United States (Feb. 2005) (unpublished manuscript), available at <http://perma.cc/V3R2-7WN4>).

¹¹¹ See *supra* sources cited and text accompanying notes 93-95.

¹¹² Rodrigues, *supra* note 15, at 3398 (citing Robert Wiltbank, At the Individual Level: Outlining Angel Investing in the United States (Feb. 2005) (unpublished manuscript), available at <http://perma.cc/K3J8-NKGD>).

investors—was 8.43 percent over that same period.¹¹³ Given these returns, and the emerging secondary markets, the illiquidity and idiosyncratic risk of private placements alone do not justify government actions that restrict the fundamental freedom of the investor.

B. Private Investment Funds

Private investment funds provide many of the same advantages to their investors as do other private placements. Their unique structure also provides several additional benefits to investors that direct investments in private companies do not. Although the idiosyncratic risks and general risk profiles of each hedge fund, private equity fund, and venture capital fund vary considerably, they all enjoy certain distinct advantages over their cousin, the registered investment fund. Besides the inherent advantages of pooled investment funds—risk spreading and the pooling of capital to generate higher returns through a larger market footprint—private funds, because of their exemption from the Investment Company Act, can adopt trading strategies to preserve wealth in times of market stress. Additionally, private funds often focus on niche investment markets and strategies generally foreclosed to mutual funds. Finally, these funds' legal structure allows for pass-through taxation, which preserves investors' capital and contributes to higher returns.

One of the most significant objectives of many private funds is principle preservation.¹¹⁴ This advantage applies especially to hedge funds.¹¹⁵ Hedge funds utilize trading strategies and hedging techniques denied to registered mutual funds by the Investment Company Act¹¹⁶ to protect principal during times of high market risk.¹¹⁷ Among other requirements, the Investment Company Act requires registered funds to offset any short positions with

¹¹³ Investment returns calculated based on data from sources cited *infra* notes 169-175.

¹¹⁴ In fact, most private equity fund investors demand a specified minimum rate of return. See, e.g., Aaron Bachik & Anthony Broglio, *Raising Equity in the Construction Industry*, CONSTRUCTION ACCT. AND TAX'N, 2000 WL 36565759 ("Investors in private equity funds typically demand returns between 25 percent and 35 percent. If an investment cannot generate such returns, regardless of its risk profile, the equity sponsors will not make the investment.").

¹¹⁵ SEC Staff Report, *supra* note 24, at 5.

¹¹⁶ Shadab, *supra* note 88, at 269.

¹¹⁷ *Id.*

corresponding long positions.¹¹⁸ Exemption from the Investment Company Act frees hedge funds from this requirement, allowing them to hedge long positions by simultaneously holding both short and long positions on the same securities.¹¹⁹ Hedge funds often utilize short selling,¹²⁰ arbitrage,¹²¹ and margin trading¹²² to amplify returns and preserve principal. In addition to hedging against the idiosyncratic risk of securities to reduce losses, these trading strategies also generate returns in declining markets because funds can realize gains from arbitrage, margin trading, and short selling irrespective of market conditions.¹²³

By employing these trading strategies, “hedge funds are uniquely able to reduce losses from market risk.”¹²⁴ In contrast, public mutual funds, “typically seek returns relative to the overall market.”¹²⁵ Consequently, “during economic downturns mutual funds typically remain invested in securities even as they continue to decrease in value.”¹²⁶ These trends result in almost no correlation between public market returns and hedge fund returns, particularly in times of market stress.¹²⁷ Even though the returns on public equity markets remain higher than returns on hedge funds, the high returns on public funds come with added exposure to market risk.¹²⁸ From 1999 to 2002, when public equity markets, as demonstrated by the S&P 500, were in sharp decline and yielding negative returns as low

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 270.

¹²⁰ Goldstein, *supra* note 24, at 116. Funds accomplish short selling by borrowing a security from a broker-dealer or market maker, selling the security, and then repurchasing the security at a lower price. The fund then returns the security to the broker-dealer, realizing the difference. *See, e.g., Introduction to the Markets: How the Markets Work: Stock Purchases and Sales: Long and Short*, INVESTOR.GOV, <http://perma.cc/K3R4-MBxB> (last visited Nov. 14, 2014).

¹²¹ *Id.* Arbitrage involves taking advantage of the unexpected price difference of a security on two markets, buying the security for a low price on one market and selling it at a higher price on another. *See, e.g., Investor Bulletin: Exchange Traded Funds (ETFs)*, INVESTOR.GOV, <http://perma.cc/9F77-3SLZ> (last visited Nov. 14, 2014).

¹²² *Id.* Margin trading refers to purchasing a security using a loan from the seller guaranteed by the proceeds from the future sale of the security. *See, e.g., Investor Bulletin: Understanding Margin Accounts*, INVESTOR.GOV, <http://perma.cc/2ZAL-RD3L> (last visited Nov. 14, 2014).

¹²³ Shadab, *supra* note 88, at 270.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 269.

¹²⁷ *See infra* Part IV.A.

¹²⁸ Shadab, *supra* note 88, at 269.

as -20 percent or more, hedge funds in fact maintained positive returns.¹²⁹

In addition to principal preservation and low market risk, another major advantage of private funds is their ability to focus on niche markets and take advantage of timing opportunities. For instance, venture capital funds and private equity funds often invest in motion picture productions and hedge funds trade in complex derivatives.¹³⁰ Public mutual funds, by comparison, are entirely absent from these markets. The managers of private funds are often activist investors as opposed to the largely passive managers of registered mutual funds.¹³¹ Activist investors use their share control of a portfolio company to prod management to make changes to increase the portfolio company's value, eventually passing the gains from activism onto the funds' investors.¹³² Successful activist fund managers, particularly of private equity funds, can often acquire drastically undervalued portfolio companies and return many times their value by the time they exit the investment.¹³³

Private funds also realize high returns by interacting with extraordinary events such as mergers and bankruptcies. Hedge funds often arbitrage the price of a public security during a tender offer or during bankruptcy.¹³⁴ Fund managers sometimes even instigate tender offers, frequently hostile, to either gain control of a target company or arbitrage the stock price.¹³⁵ The typical *modus operandi*

¹²⁹ *Id.* at 290.

¹³⁰ *Id.* at 263.

¹³¹ *Id.* at 270-71.

¹³² *Id.* This perhaps explains why only private funds focus on niche markets like emerging companies and film productions—the higher risk of failure motivates the fund manager to take a much more active role in the portfolio company in order to protect their investment.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ Or perhaps both. For example, activist investor William Ackman, through his hedge fund Pershing Square Capital Management L.P. and its subsidiaries PS Management G.P., PS Fund 1 LLC, and AGMS, Inc., acquired large amounts of stock in Allergan, Inc., while at the same time financing the tender offer of Valeant Pharmaceuticals International, Inc., for Allergan stock. Evidently, Ackman sought his shares both (1) to gain enough voting power to force Allergan to accept the tender offer and (2) sell his shares to Valeant if the tender offer succeeded. Complaint at 13-18, *Allergan, Inc. v. Valeant Pharmaceuticals, Int'l, Inc.*, No. 8:14-cv-01214, 2014 WL 3809192 (C.D. CA, Nov. 1, 2014). When Actavis emerged as a white knight and topped the Valeant bid, Ackman's hedge fund remained able to sell its Allergan stock to Actavis for a considerable profit (and without having to expend capital financing the Valeant bid). See Antoine Gara, *Allergan Agrees to \$219 A*

of a private equity fund is to gain control of a company through a leveraged buyout, then repay the acquisition debt out of the free cash flow of the acquired company.¹³⁶ When the fund exits the investment, only minimal debt will remain, leaving investors free to realize large returns (and preserving investors' capital relatively risk-free during the period the private equity fund retains ownership of the portfolio company).¹³⁷ Venture capital funds typically acquire early-stage companies and exercise an activist investing strategy, hoping to improve the value of the portfolio company by providing management advice and other support.¹³⁸ The market often views venture capital investments as "smart money," and the mere fact of a venture capital fund investment may increase the purported value of the target.¹³⁹ Successful venture capital funds frequently provide investor returns ranging from 16 to 20 percent per year¹⁴⁰—higher than the 13 percent average annual yield on the S&P 500.¹⁴¹

Public markets often find themselves the inevitable losers when private funds engage in investment arbitrage or take companies private.¹⁴² If a fund succeeds in acquiring a publicly traded company, average investors (restricted to public markets) realize the control premium or the market price upswing prior to the acquisition, but do not share in the subsequent gains the fund realizes.¹⁴³ Only the fund investors—accredited investors and qualified purchasers—receive the benefit of subsequent gains after funds improve the portfolio company's profitability.¹⁴⁴ When tender offers or leveraged buyouts fail, however, the price of the once-target typically plummets, punishing average investors. Meanwhile, the principal of the hedge fund or private equity fund remains unaltered. This dynamic is even worse looking at venture capital funds, because their target companies are rarely public and average investors do not even realize a control premium.¹⁴⁵ Consequently, only the securities laws'

Share Actavis Takeover Over Bill Ackman-Backed Valeant Deal, FORBES, available at <http://perma.cc/99FK-FEL4> (Nov. 17, 2014).

¹³⁶ See SIMON M. LORNE & JOY MARLENE BRYAN, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 6:2-3 (2014).

¹³⁷ *Id.*

¹³⁸ Rodrigues, *supra* note 15, at 3400-01.

¹³⁹ *Id.* at 3401.

¹⁴⁰ *Id.*

¹⁴¹ Calculated based on data from sources cited *infra* note 169.

¹⁴² Rodrigues, *supra* note 15, at 3429.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ See *supra* sources cited and text accompanying notes 93-95.

investing elite ever participate in the successful venture capital investment.¹⁴⁶ The result is a situation whereby, “average investors are net losers . . . because of government regulation they cannot participate in the profits that private equity funds make, while nevertheless must share in the losses.”¹⁴⁷

Another major advantage of private funds is pass-through taxation. Most private funds choose the limited partnership or the LLC as their corporate form.¹⁴⁸ As partnerships, the investment funds themselves do not pay taxes.¹⁴⁹ Rather, the funds impute their earnings to their beneficial owners, who pay taxes at their individual levels.¹⁵⁰ This structure avoids the “double-taxation” problem of public corporations,¹⁵¹ allowing funds to pass the tax savings on to investors in the form of higher net returns.¹⁵² Many private equity fund investors are tax-neutral or tax-exempt entities like public pension plans or government treasuries,¹⁵³ meaning that some fund earnings escape taxation altogether!

The SEC, meanwhile, characterizes many of the significant advantages of private funds as reasons to lock average investors out of making investments.¹⁵⁴ This perspective derives from the fundamental premise of the federal securities laws that disclosure of information is the best mechanism for protecting investors from fraud.¹⁵⁵ From an investor standpoint, illiquidity is the major drawback to private funds. To generate their large yields on portfolio companies, venture capital funds and private equity funds have exit

¹⁴⁶ Rodrigues, *supra* note 15, at 3429.

¹⁴⁷ *Id.*

¹⁴⁸ Goldstein, *supra* note 26, at 114-15.

¹⁴⁹ See generally SCOTT SHIMICK, 8 MERTENS LAW OF FEDERAL INCOME TAXATION § 33:03-14 (2014).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* “Double taxation” refers to the fact the corporation pays income taxes and its investors subsequently pay taxes on dividends and other distributions, taxing the earnings twice.

¹⁵² Goldstein, *supra* note 26, at 114-15.

¹⁵³ The “Prudent Man Rule” Clarification of 1979 clarified that government treasuries and pension funds could participate in private placements and alternative investments. See 44 Fed. Reg. 37,221, 37,222 (June 26, 1979). Since then, the number of large pension programs investing in private equity has exploded. For instance, the California Public Employees Retirement System (CalPERS) has \$5.6 billion assets under management devoted to private equity as of 2013. CALPERS, COMPREHENSIVE ANNUAL FINANCIAL REPORTS (2013), available at <http://perma.cc/6BZ9-8HRM>.

¹⁵⁴ Goldstein, *supra* note 26, at 114-15.

¹⁵⁵ SEC Release 8766, *supra* note 10, at 8.

horizons of five to ten years after the initial investment.¹⁵⁶ Even though the investment strategy of hedge funds does not necessarily rely on taking such extremely long positions, hedge funds nevertheless restrict the ability of investors to redeem and transfer their interests.¹⁵⁷ As discussed previously, however, illiquidity is, in some cases, extremely advantageous to the properly diversified portfolio.¹⁵⁸

As with angel investments, private funds come with high levels of idiosyncratic risk.¹⁵⁹ In the rare cases when hedge fund losses are actually negative, they can be jaw dropping.¹⁶⁰ These potential losses are one reason why the SEC believes private funds should remain restricted to a limited number of wealthy, sophisticated investors.¹⁶¹ At the same time, the fact that many extremely sophisticated institutional investors have lost millions in private funds evidences why they are not necessarily worthy to have their own special kingdom of exclusive, private investments.¹⁶² The

¹⁵⁶ Rodrigues, *supra* note 15, at 3401; SEC. & EXCH. COMM’N., IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, 7-8 (2003).

¹⁵⁷ Shadab, *supra* note 88, at 250-51.

¹⁵⁸ See *supra* Part II.A.

¹⁵⁹ Shadab, *supra* note 88, at 274.

¹⁶⁰ *Id.* For instance, during the 2008 financial crisis, IKB Deutsche Industriebank (a German bank) and ACA Capital Management (a U.S. money manager) suffered losses of \$150 million and \$841 million on a collateralized debt obligation (“CDO”) tied to derivative swaps involving mortgage-backed securities (“MBS”). Oguss, *supra* note 14, at 305-06. Paulson & Co., a hedge fund, had marketed the CDO (through Goldman-Sachs, which lost \$100 million), but failed to disclose the fact that the hedge fund was shorting the MBS market at the same time. *Id.* Five Wisconsin school district pension funds invested in hedge funds also collectively lost \$37 million on CDOs tied to MBS in 2008. *Id.* at 307. In the mid-1990s, several large institutional investors, including Orange County California, Proctor & Gamble, and Gibson Greetings, suffered losses of as much as \$157 million on derivative swaps marketed by various hedge funds. *Id.* at 302. Famously, thousands of investors in Bernie Madoff’s Ponzi scheme, which Madoff marketed as an exempt pooled investment program, lost a staggering \$64.8 billion. Smith, *supra* note 14, at 218-19. Most of the investors in Madoff’s funds were sophisticated investors or accredited investors and included many mutual fund and hedge fund managers and philanthropic entities. *Id.* at 232-33. At the same time, some of the investors were reasonably average individuals with income and net worth levels barely past the minimum thresholds for Accredited Investor and Qualified Purchaser qualification. *Id.* at 233-34.

¹⁶¹ See, e.g., Lee, *supra* note 16, at 990-91; SEC Release 8766, *supra* note 10, at 7-9.

¹⁶² Smith, *supra* note 14, at 220 (“In light of these developments, policy makers should re-examine the wisdom of continued reliance on the statutory model that leaves sophisticated investors to fend for themselves”). The losses from the Paulson CDO collapse and the Madoff Ponzi scheme resulted from blatant fraud. *Id.* at 215-

fact remains that any poorly diversified investor can potentially lose their entire investment—whether that investment is in public or private investment instruments.¹⁶³

While these concerns do make private funds idiosyncratically risky, they also provide many noted advantages to investors that public securities do not. All investing involves some degree of risk. The securities laws, therefore, should “enable all investors . . . to participate in capital markets according to the particular investor's choice and tolerance for risk.”¹⁶⁴ To do otherwise is to perpetuate a regime that will invariably result in a greater separation between those admitted inside the gates of the private placement kingdom and those locked outside.

IV. HOW THE ADVANTAGES OF PRIVATE PLACEMENTS FACILITATE WEALTH INEQUALITY

Denying average middle class investors access to private placements places them at a distinct disadvantage *vis-à-vis* wealthy accredited investors and qualified purchasers in two significant respects. First, the investment options available to middle class investors largely lack the principal preservation capacity that private placements possess by virtue of their isolation from market risk¹⁶⁵ and the unique trading strategies they employ.¹⁶⁶ In times of market

16; Oguss, *supra* note 14, at 305-06. For its role in the Paulson CDO collapse, Goldman Sachs paid a penalty of \$550 million for issuing marketing materials with “incomplete information” by virtue of not disclosing Paulson’s fund held both short and long positions on MBS. Oguss, *supra* note 14, at 306. Irving Picard, the federally appointed trustee for the Madoff investment recovery, filed lawsuits attempting to recover \$44.8 million from Madoff’s wife and \$10.1 billion that he characterized as fictitious profits paid to early investors. Smith, *supra* note 14, at 224. Madoff himself is serving 150 years in federal prison. *Id.* at 216. Even the most robust disclosure regime cannot completely foreclose losses proximately caused by fraudulent schemes. *See generally* Smith, *supra* note 14. Further, looking at the staggering losses of one party only tells half of the story. While the Goldman Sachs, IKB, and ACA lost millions on derivative swaps, Paulson’s hedge fund—and its investors—made over \$1 billion on the same swaps. Oguss, *supra* note 14, at 306.

¹⁶³ *See generally* Rodrigues, *supra* note 15, at 3428; Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL’Y 251, 269-70 (2008); Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 264.

¹⁶⁴ Smith, *supra* note 14, at 282-83.

¹⁶⁵ *See supra* sources cited and text accompanying notes 100-06.

¹⁶⁶ *See supra* sources cited and text accompanying notes 114-41.

stress, greater preserved principal allows many private placements to realize higher cumulative return multiples than public equities, even accounting for illiquidity. Second, the principal preservation tools that are available to average investors—such as the bond markets and treasury notes—are poor portfolio diversification instruments relative to private placements. Middle class investors are therefore unable to adequately maximize risk-adjusted returns. This Part will first compare private and public investment returns with a particular focus on the effects of principal preservation in times of market stress. The analysis will then proceed to discuss the inequities implicit in denying average investors greater diversification options. Finally, this Part will outline the current and historical number of accredited investors and qualified purchasers and explain how private placement investment returns permit these groups to accumulate greater wealth than the middle class.

A. Private Placement and Public Market Returns Compared

In the aggregate, the public stock markets tend to outperform private securities.¹⁶⁷ Of the six asset classes examined below—public stocks, bonds, ten-year treasury bonds, hedge funds, private equity funds, and venture capital funds—only private equity funds and venture capital funds yield higher average returns than public equities.¹⁶⁸ Presently, the securities laws limit non-accredited investors seeking investments with steady returns and relatively low market risk to public debt and treasury notes, both of which provide only modest inflation-adjusted returns on investment. Qualified purchasers, meanwhile, can diversify their portfolios by investing in hedge funds, with higher inflation-adjusted returns than public debt and lower market risk than public equity. They also have the opportunity to earn steady—and sometimes spectacular—returns by investing in private equity funds and venture capital funds. The chart below compares the returns of public stocks (represented by the S&P 500 Index), bonds, the ten-year U.S. Treasury Note, hedge funds, private equity funds, and venture capital funds from 1997 to 2013.

¹⁶⁷ Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 269.

¹⁶⁸ See *infra* sources cited and text accompanying notes 169-75.

1997-2013	S&P 500 ¹⁶⁹	Bond s ¹⁷⁰	Ten Year T-Note ¹⁷¹	Hedge Funds ¹⁷²	Private Equity Funds ¹⁷³	Venture Capital Funds ¹⁷⁴
Average Annual Return	9.34%	5.75%	5.95%	9.53%	14.82%	11.31%
Inflation-Adjusted Total Return ¹⁷⁵	124.30%	70.59%	66.82%	182.73%	377.58%	168.52%

Even though annualized private fund returns on balance tend to be lower than public markets, they are usually steady and rarely negative. For example, from 1998 to 2013, hedge funds had only two years of negative returns.¹⁷⁶ A similar picture emerges for private equity and venture capital funds. From 1997 to 2013, venture capital funds and private equity funds each had only four years of negative

¹⁶⁹ Calculated based on data from ANNUAL RETURNS ON STOCK, T. BONDS, AND T. BILLS: 1928 – CURRENT, *available at* <http://perma.cc/DV73-J2L8> (last visited Oct. 19, 2008).

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² Calculated based on the Barclay's Fund of Hedge Fund Index, BARCLAYHEDGE ALTERNATIVE INVESTMENT DATABASES, *available at* <http://perma.cc/XYD7-7J3D> (last visited Nov. 14, 2014)). Data is not available for years prior to 1997.

¹⁷³ Calculated based on data from Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?* J. OF FIN. 33-34 (July 2013) supplemented by returns provided by CALPERS, COMPREHENSIVE ANNUAL FINANCIAL REPORTS (2001-2014), *available at* <http://perma.cc/FKB3-HGV3>; and returns provided by WASHINGTON STATE INVESTMENT BOARD, PORTFOLIO OVERVIEW BY STRATEGY (2003-2014), *available at* <http://perma.cc/SV75-Y8R3>. See Appendix B for the methodology used to imply annual returns for private equity funds.

¹⁷⁴ *Id.* See Appendix C for the methodology used to imply annual returns for venture capital.

¹⁷⁵ To determine this figure, the theoretical one-year return of a \$1,000 initial investment was calculated and then adjusted for inflation. The result was then reinvested and the return for the following year computed and adjusted for inflation, the process continuing through the final year. Annual returns were based on data provided in sources cited *supra* notes 174-79. Inflation based on the consumer price index, annual data provided by U.S. INFLATION CALCULATOR, <http://perma.cc/48LT-V7Q9> (last visited Nov. 16, 2014).

¹⁷⁶ Calculated based on data from sources cited *supra* notes 169-75.

returns.¹⁷⁷ The infrequent occurrence of negative returns allows private funds to preserve principal, resulting in greater compounding relative to public markets and consequently higher aggregate return multiples

Principal preservation and subsequent compounding facilitate wealth accumulation for those select few able to invest in private funds. A simple data analysis of two periods of public market downturns—the technology bubble collapse in the late-1990s and the financial crisis of 2008—demonstrates this outcome. Exhibit 1 provides the average annual returns on five asset classes from 1997—just before the peak of the technology bubble—until 2005 when the public financial markets began to recover in earnest.¹⁷⁸ From 1997 to 1999, the S&P 500 posted declining annual returns, and outright negative returns from 2000 to 2002.¹⁷⁹ Meanwhile, private fund returns (except venture capital) remained largely positive up until 2002 (and even saw increasing returns while public market returns declined).¹⁸⁰ Returns on venture capital funds, due to their heavy investment in the technology bubble, declined from almost 100 percent in 1998 to negative -15.23 percent in 2000.¹⁸¹ Hedge fund returns over the period remained both positive and relatively constant.¹⁸² From 1998 to 2003, every investment class spare venture capital funds outperformed public debt.¹⁸³ Until markets recovered in 2003, private funds continued to generate higher annual returns than public equities, demonstrating their capital preservation abilities.¹⁸⁴ The fact that fluctuations in private fund returns bear little connection to broader market trends demonstrates that private investments are in fact isolated from market risk.¹⁸⁵

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

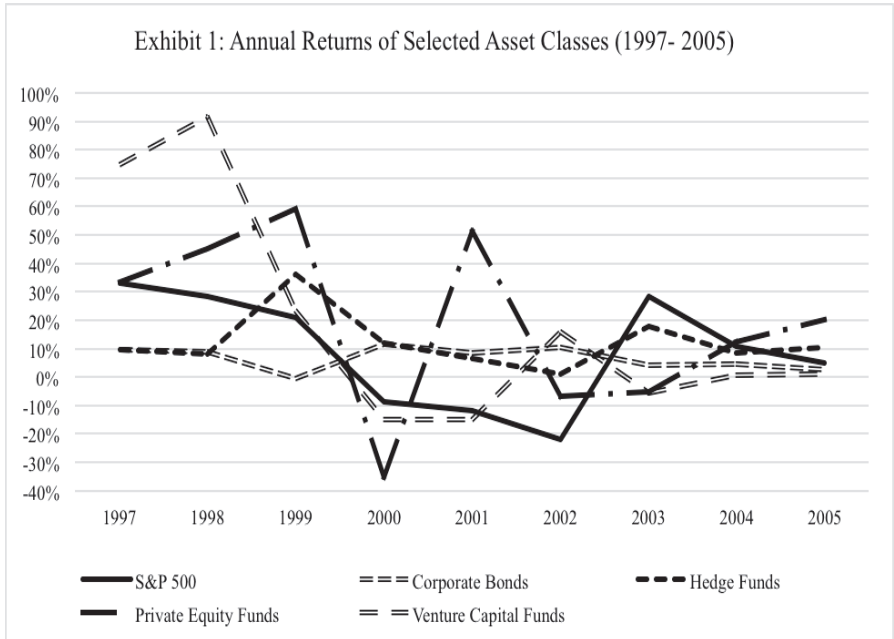
¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ See *supra* sources cited and text accompanying notes 93-95.



The direct connection to wealth accumulation becomes apparent when looking at the compounding power of principal preservation. Exhibit 2 demonstrates the theoretical growth (or decline) in the value of a \$1,000 investment made in each public equity, public debt, and private funds in 1997.¹⁸⁶ An investment in public markets posts a positive total return of 93 percent, despite negative returns and corresponding principal loss from 2000 to 2002.¹⁸⁷ An investment in a private fund, however, generates return on investment of at least 180 percent over the same period.¹⁸⁸ Venture capital funds, despite steep declines in returns and years with returns below zero, still left the second-highest amount of capital for investors.¹⁸⁹ Every asset class, meanwhile, outperformed public debt.¹⁹⁰ These results demonstrate the unique power that wealthy qualified purchasers have to retain and grow wealth relative to the market at large.

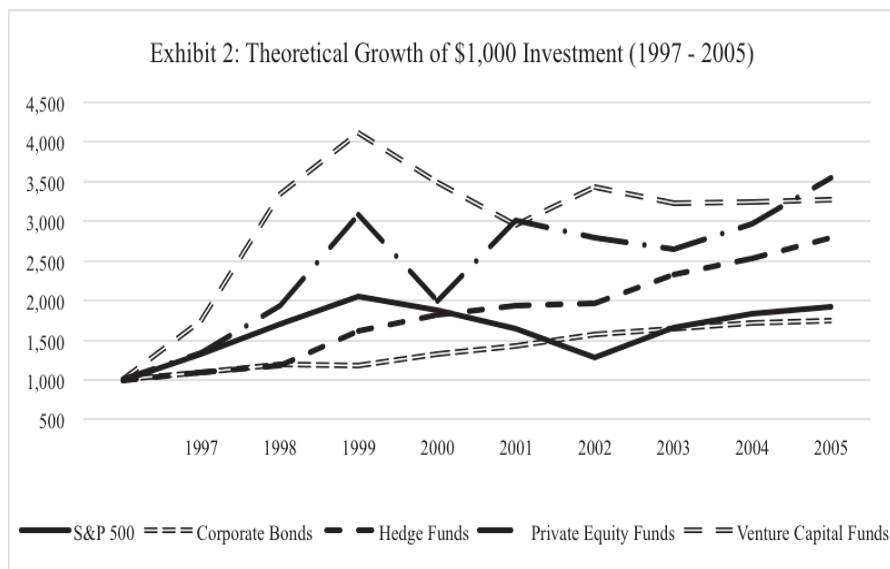
¹⁸⁶ See *supra* sources cited and text accompanying notes 169-75.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*



The 2008 financial crisis provides an even more demonstrative case study because of the behavior of private fund returns. Unlike in 1999, when the technology bubble collapse barely affected private funds (except for venture capital), they did not emerge unscathed from the 2008 financial crisis.¹⁹¹ Hedge fund returns from 2006 to 2013 closely tracked public market returns, mainly because of their heavy exposure to the mortgage-backed securities (“MBS”) at the root of the financial collapse.¹⁹² Their exposure to MBS, however, remained lower than the exposure of public markets to MBS.¹⁹³ This lower exposure is why, despite posting record losses, hedge funds still posted higher returns than public markets and their performance relative to public markets was at an all-time high.¹⁹⁴ Private equity funds and venture capital funds posted highly erratic returns over this period, although any losses they suffered were insignificant compared to the over one-third decline in the value of public markets over this period.¹⁹⁵

¹⁹¹ Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 291-92 (“In 2008, hedge funds suffered the worst losses in their history. Hedge funds lost 19 percent and their investors withdrew a record \$1.28.91 billion in capital.”).

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ Calculated based on data from sources cited *supra* notes 169-75.

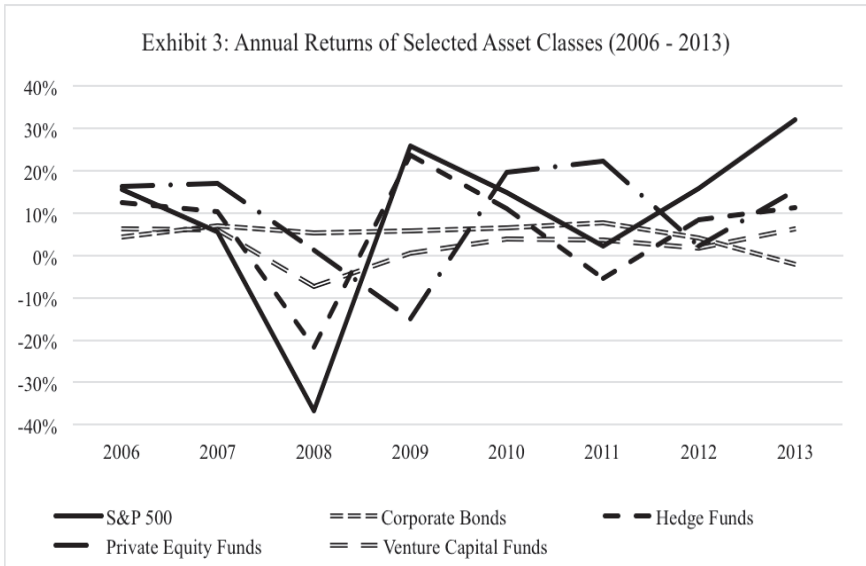
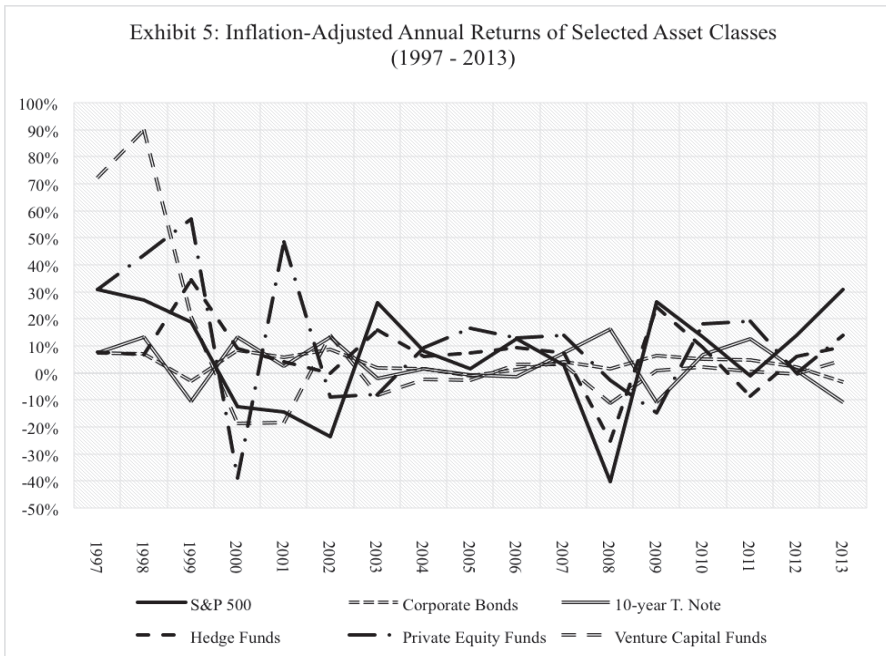
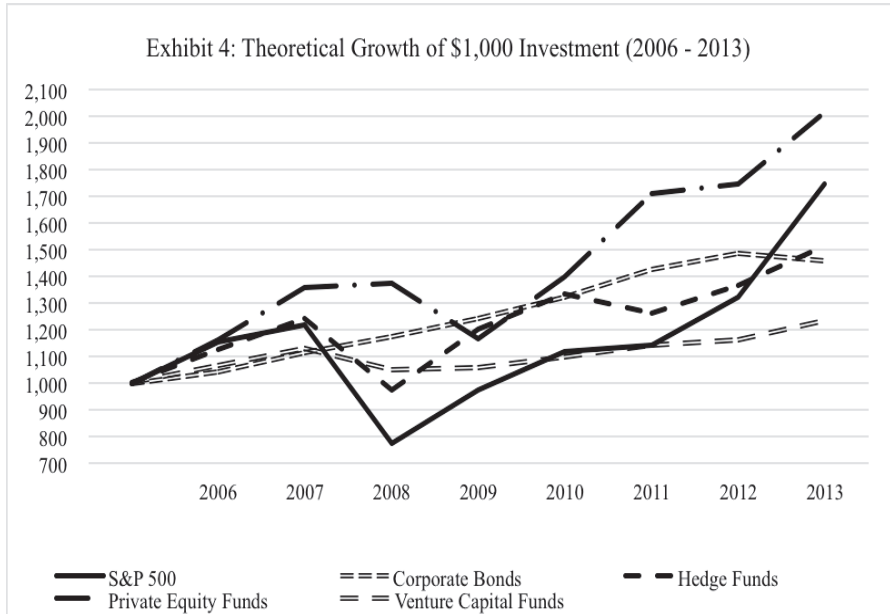


Exhibit 3 outlines the average returns of public markets and private placements from 2006, just before the financial crisis, through 2013.¹⁹⁶ The power of compounding under these market conditions is telling of the problem facing the average investor. Despite hedge fund returns roughly tracking public market returns, investors in hedge funds retained significantly greater principal than public investors. Earlier compounding and slightly smaller losses meant that hedge fund investors earned greater return on investment even after public markets recovered and posted annual returns higher than private funds. The total cumulative return on a public investment from 2006 to 2013 was 75 percent, as compared to a hedge fund cumulative return of 51 percent or a private equity fund return of 102 percent.¹⁹⁷ Exhibit 4, showing the theoretical growth of a \$1,000 investment from 2006 to 2013, graphically depicts the resulting wealth accumulation.¹⁹⁸

¹⁹⁶ *Id.*

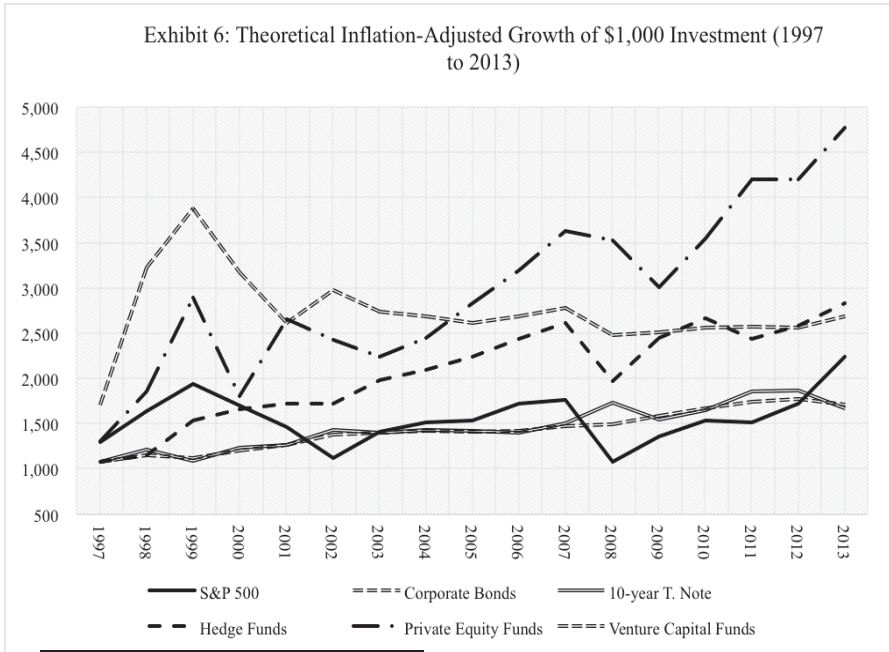
¹⁹⁷ *Id.*

¹⁹⁸ *Id.*



Exhibits 5 and 6 chart these same effects from 1997 to the

present,¹⁹⁹ clearly demonstrating the aggregate effects of low market risk, capital preservation, and other advantages of private funds. As shown by Exhibit 5,²⁰⁰ private placement returns, excepting private equity funds, remain on balance lower than public stocks. Concurrently, Exhibit 6²⁰¹ shows that of the six asset classes examined, a \$1,000 investment in 1997 in both hedge funds and private equity funds would have left an investor with more capital in 2013 than a similarly timed investment in public stocks. These theoretical models assume that investors withdraw no invested principal during the measuring period, which means that private placements yield higher overall return multiples even accounting for their illiquidity. Meanwhile, returns on bonds and treasury securities barely outpace inflation.²⁰² These outcomes show that qualified purchasers diversified in private placements and public equities will drastically outperform non-accredited investors diversified in public equities and bonds. This inadequate diversification is the mechanism by which wealthy accredited investors and qualified purchasers accumulate much greater wealth relative to the middle class.



¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

B. The Inequities of Inadequate Portfolio Diversification

Portfolio diversification, the act of spreading investment capital among a variety of different asset classes, plays a critical role in both maximizing returns and minimizing risks.²⁰³ According to Shadab:

“Modern portfolio theory” focuses on those returns attributable to risk and teaches that investors should seek to maximize risk-adjusted returns. . . . Risk-adjusted returns are maximized when, taking into account the different measures of risk, an investor is receiving the highest possible return for the total amount of risk they are taking on. To maximize risk-adjusted returns, investors should therefore invest in an efficient portfolio that yields the highest return for the level of market risk that they are willing to bear.²⁰⁴

Presently, the securities laws deny average investors the opportunity to invest in private placements, which also denies them the opportunity to diversify sufficiently their portfolios to take advantage of differing risk profiles. Although public stock markets tend to post the highest average annual returns, they also come with the most risk.²⁰⁵ At the same time, the securities laws leave non-accredited investors seeking to diversify away from public markets only limited options, all of which are inferior to private placements. The securities laws therefore force middle class investors seeking to maximize returns to bear greater risk than they would prefer.

The risk profile of an investment is often approximated using the risk premium, the excess return of a risk-prone investment over a “riskless” alternative, typically U.S. treasury notes.²⁰⁶ The table below shows the average risk premiums of each public stock markets, bonds, angel investments, hedge funds, private equity funds, and venture capital funds.²⁰⁷

²⁰³ Shadab, *Fending for Themselves*, *supra* note 163, at 269-70.

²⁰⁴ Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 264.

²⁰⁵ Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 269.

²⁰⁶ See, e.g., *Investment Statistics*, EVESTMENT, <http://perma.cc/5LJ2-ZDDF> (last visited Feb. 7, 2015). This analysis utilizes the ten-year U.S. Treasury Note as a benchmark.

²⁰⁷ Calculated based on data from sources cited *supra* notes 169-75.

1997-2013	S&P 500	Bonds	Angel Investments	Hedge Funds	Private Equity Funds	Venture Capital Funds
Average Risk Premiums	0.69% — 3.39%	(-2.68) — (-0.20%)	1.15% ²⁰⁸	3.67% — 4.31%	4.60% — 8.87%	1.00% — 5.35%

Using the S&P 500 as a benchmark, the public equity market yields an elevated risk premium of as high as 3.39 percent for the period of 1997 to present.²⁰⁹ By way of comparison, private placement risk premiums vary between one percent and 8.87 percent.²¹⁰ Bond markets, the traditional method of diversifying portfolio risk, yield a negative risk premium of between -2.68 percent and -0.20 percent.²¹¹ The negative risk premium on bonds means that their average returns are so low that they underperform the virtually guaranteed returns on treasury notes and barely keep pace with inflation. As shown by Exhibit 6, the 1997 to 2013 inflation-adjusted returns of every single asset class surpass the bond market.²¹² Middle class investors seeking portfolio diversification therefore face a prisoner's dilemma: either divert capital into the underperforming bond market, or remain heavily invested in the volatile public stock markets.

Despite this undesirable predicament, the federal securities laws indiscriminately allow average investors to "lose their shirts"²¹³ investing on the public stock markets (and in a variety of other ways)²¹⁴ but lock them out of private markets entirely. In principle, the individual investor's own risk tolerance should determine what degree of risk the investor is willing to undertake.²¹⁵ Taking freedom from the individual investor and handing it to the government is at

²⁰⁸ Assumes a 10 percent average return. See Rodrigues, *supra* note 15, at 3398 (citing Robert Wiltbank, At the Individual Level: Outlining Angel Investing in the United States (Feb. 2005) (unpublished manuscript), available at <http://perma.cc/34X5-K7P3>).

²⁰⁹ Calculated based on data from sources cited *supra* note 169-75.

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ Rodrigues, *supra* note 15, at 3428-29.

²¹⁴ For instance, no federal law stops anyone from buying hundreds of lottery tickets in hopes of winning a Mega Millions or Powerball jackpot, the odds of which are significantly worse than the odds of losing money on a private placement.

²¹⁵ Shadab, *The Law and Economics of Hedge Funds*, *supra* note 88, at 264.

best inefficient,²¹⁶ at worst, proof that Congress does not trust the middle class.

C. Left Behind: The Middle Class Relative to the Securities Laws' Investing Elite

In enacting the Small Business Investment Incentive Act of 1980, Congress sought to restrict private placements to the already wealthy,²¹⁷ ostensibly because they were better able to “fend for themselves.”²¹⁸ Over the following 35 years, however, the unique ability of wealthy investors in private placements to amplify aggregate returns by preserving principal, coupled with inadequate portfolio diversification options for non-accredited investors, has permitted these investing elite to become even wealthier relative to the middle class. While both the total number of the securities laws' investing elite—accredited investors and qualified purchasers—has actually increased, along with their relative proportion of all American households, they remain a small fraction of the total population. The following table outlines the approximate number of accredited investors and qualified purchasers in six-year intervals starting in 1986.

	198 6 ²¹⁹	198 9 ²²⁰	199 2 ²²¹	199 5 ²²²	199 8 ²²³	2001 224	200 4 ²²⁵	200 7 ²²⁶	201 3 ²²⁷
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²¹⁶ See Lee, *supra* note 16, at 997-98, 1000-01.

²¹⁷ See *supra* sources cited and text accompanying notes 47-51.

²¹⁸ Sec. and Exch. Comm'n. v. Ralston Purina Co., 346 U.S. 119, 124-26 (1953).

²¹⁹ Calculated using statistics from Marvin Schwartz & Barry W. Johnson, *Estimates of Personal Wealth, 1986*, INTERNAL REVENUE SERV. 71 (1986), available at <http://perma.cc/V9JQ-NBEM>.

²²⁰ Calculated using statistics from Barry W. Johnson & Marvin Schwartz, *Personal Wealth, 1989*, INTERNAL REVENUE SERV. 114 (1989), available at <http://perma.cc/ZRC4-P7ZK>.

²²¹ Calculated using statistics from Barry W. Johnson, *Personal Wealth, 1992-1995*, INTERNAL REVENUE SERV. 84 (1995), available at <http://perma.cc/P8FU-WXGL>.

²²² Calculated using statistics from Barry W. Johnson, *Personal Wealth, 1995*, INTERNAL REVENUE SERV. 75 (1995), available at <http://perma.cc/7K89-L4Z2>.

²²³ Calculated using statistics from Barry W. Johnson & Lisa M. Schreiber, *Personal Wealth, 1998*, INTERNAL REVENUE SERV. 103 (1998), available at <http://perma.cc/G87H-RXY8>.

²²⁴ Calculated using statistics from Barry W. Johnson & Brian G. Raub, *Personal Wealth, 2001*, INTERNAL REVENUE SERV. 136 (2001), available at <http://perma.cc/9NPY-63KX>.

²²⁵ Calculated using statistics from Brian G. Raub, *Personal Wealth, 2004*, INTERNAL REVENUE SERV. 298 (2004), available at <http://perma.cc/HN2G-KGAV>.

Accredited Investors (thousands)	941	1,266	1,303	1,572	2,744	3,509	2,196	1,840	8,691
Percent of all U.S. Households	0.91	1.13	1.15	1.33	2.20	2.69	1.66	1.29	7.40
Qualified Purchasers (thousands)	Not relevant - prior to enactment of Investment Company Act section 3(c)(7)			122	246	366	357	468	1,431
Percent of all U.S. Households				0.10	0.20	0.28	0.27	0.33	1.22

At best, as of 2013, only about 7.4 percent of American households qualify as accredited investors and approximately 1.22 percent as qualified purchasers.²²⁸ Based on IRS SOI statistics, from 1986 to 2007 approximately 1.5 percent of American households historically qualified as accredited investors.²²⁹ The average percentage of Americans meeting the standard for qualified purchaser over the same period was, at most, 0.40 percent.²³⁰ High inflation, the significant increase in the value of personal residences, and sustained growth of income in the 1990s resulted in an increase in the number of individuals qualifying as accredited investors and qualified purchasers in the early 2000's.²³¹ Nevertheless, the securities laws still preclude 93 percent of U.S. households from investing in all private placements and 99 percent of households from investing in private investment funds.

²²⁶ Calculated using statistics from Brian Raub & Joseph Newcomb, *Personal Wealth, 2007*, INTERNAL REVENUE SERV. 169 (2007), available at <http://perma.cc/2JGL-6X8T>.

²²⁷ Estimates based on SEC Division of Economic and Risk Analysis study, see *Disqualification of Bad Actors*, *supra* note 34, at 44756.

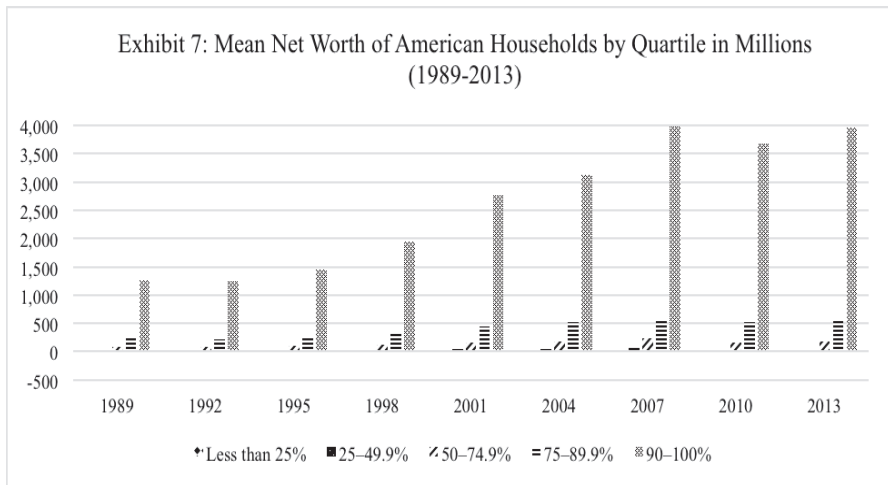
²²⁸ *Id.*

²²⁹ Calculated based on IRS SOI statistics. See sources cited *supra* notes 219-27.

²³⁰ *Id.*

²³¹ SEC Release 8766, *supra* note 10, at 24. The decline in home values proceeding (or perhaps precipitating) the 2007 financial crisis prompted Congress and the SEC to exclude primary residences from the Accredited Investor net worth calculation in 2011. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, 124 Stat. 1376, § 413(a) (2010); Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81793-02 (Dec. 29, 2011).

While the securities laws kept the middle class out of private placements, the proportion of wealth concentrated in those eligible to invest grew. Through 1995, the percentage of total household wealth held by the top ten percent of households was approximately 79 percent.²³² This disparity began to increase in 1995 after Congress enacted NSMIA, which inaugurated the qualified purchaser standard and the dramatic growth of private investment funds.²³³ As Exhibit 7 shows, the concentration of wealth in the top ten percent of American households (approximately the same percentage of households qualifying as accredited investors) has increased dramatically—approximately 174 percent—since 1995.²³⁴ By 2013, the portion of wealth held by the top ten percent had grown to over 84 percent of all household wealth.²³⁵ This growth came largely at the expense of the middle two quartiles, which saw their percentage of household wealth decline from 7.17 percent in 1995 to 4.54 percent in 2013.²³⁶



Side-by-side comparison of growing wealth concentration and private placement returns shows the direct correlation between growing wealth disparity and private placement returns. Taking 1997

²³² Calculated based on data from FED. RESERVE SYS., SURVEY OF CONSUMER FINANCES (2013), available at <http://perma.cc/9RN7-NA6D>.

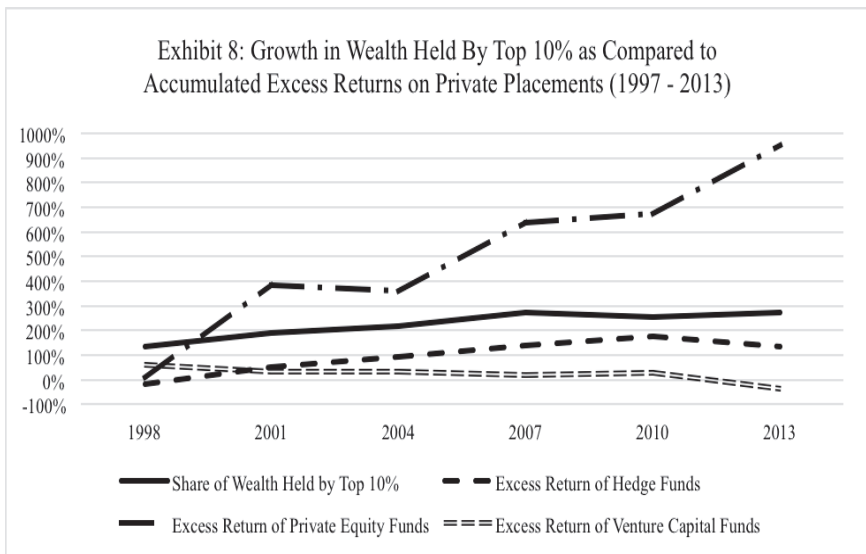
²³³ See *supra* Part II.B.

²³⁴ Calculated based on data from sources cited *supra* note 232.

²³⁵ *Id.*

²³⁶ *Id.*

as a baseline, Exhibit 8 charts four different functions over the period of 1998 to 2013. First, it charts the growth in wealth concentration in the top ten percent of Americans as a percentage of the wealth held by the top ten percent in 1997.²³⁷ A result of 191.07 from this function indicates that 91.07 percent more wealth was concentrated in the top ten percent as compared to 1997. Second, Exhibit 8 gives the accumulated excess returns of each of the three classes of private funds as against the S&P 500. The excess return is a measure of the return realized on an investment greater than an alternative benchmark. Here, the cumulative excess return provides the total return (over time) of a private investment greater than a similarly timed investment in the S&P 500. An aggregate excess return of 177.92 means that a private fund investment made in 1997 returned 77.92 percent more than an S&P 500 investment made in 1997. In short, the cumulative excess return shows the total capital returned to qualified purchasers that the securities laws currently deny to the middle class.



²³⁷ Exhibit 8 uses 1997 as a baseline for two reasons. First, confident approximate returns are available for all three classes of private funds exist from 1997 to 2013. See *supra* comment to note 174. Second, Congress enacted NSMIA in 1995, which created the qualified purchaser standard and caused both the expansion of private funds and their exclusive availability to the wealthy. See *supra* sources cited and text accompanying notes 73-76.

Running Pearson's Correlation Coefficient²³⁸ on the excess returns of each class of private funds as compared to the growth in wealth concentration shows a strong positive correlation between the two functions. Out of a possible maximum coefficient of 1.0 (perfect positive correlation), the correlation between wealth concentration and private fund excess returns is at least 0.75. Running a T-Test²³⁹ shows that the correlation is statistically significant with a confidence level of at least 98 percent. This means that a strong statistical relationship exists between private placement excess returns and wealth inequality, a relationship that the federal securities laws actively enable.²⁴⁰

Correlation between wealth concentration and private fund returns (1997 – 2013)	Pearson's Correlation Coefficient, 0.0 < 1.0 (<i>r</i>)	Confidence Level (<i>t</i>)
Hedge Funds	0.94	99.87%
Private Equity Funds	0.94	99.87%
Venture Capital Funds	0.75	97.95%

By no means is this analysis reductionist; there are innumerable reasons for the growth in wealth disparity in the United States. At the same time, as French economist Thomas Piketty has recently—and famously—elucidated, return on investment

²³⁸ See FREEMAN F. ELZEY, A FIRST READER IN STATISTICS 67-70 (Brooks/Cole Publishing Company, 2nd ed., 1974). Pearson's product-moment correlation coefficient (*r*) is a common measure of whether or not a correlation between two potentially related number sets exists, where an *r* value of -1.0 is a perfectly negative correlation, 1.0 is a perfectly positive correlation, and 0 is no correlation whatsoever. The coefficient is given by the formula

$$r = \frac{\sum_{i=1}^n (x_i - \bar{x})(y_i - \bar{y})}{\sqrt{\sum_{i=1}^n (x_i - \bar{x})^2} \sqrt{\sum_{i=1}^n (y_i - \bar{y})^2}}$$

²³⁹ *Id.* at 56-62. A simple one-tail t-test provides the sample distribution, the likelihood that a relationship is statistically significant, and not just the result of

random error. The result is given by the formula $t = \frac{r \sqrt{\frac{n-2}{1-r^2}}}{1}$

²⁴⁰ Of course, *correlation* by itself does not necessarily imply *causation*. At the same time, given the extensive work linking wealth inequality to capital returns, see PINKETTY, *infra* note 241, a causal relationship seems easy to imply from the strong correlation results.

invariably exceeds the overall growth of the economy.²⁴¹ Generating high returns on invested capital is essential to retaining and growing wealth.²⁴² The fact that the U.S. securities laws provide a kingdom of exclusive investments to the highest echelons of the wealthy is only one among many reasons wealth inequality is on the rise. Yet this should not be the case. The public policy of our securities laws should be to promote market fairness and efficiency, not facilitate economic disparity. It is time to level the playing field and give the average investor the keys to the kingdom.

V. GIVING THE AVERAGE INVESTOR THE KEYS TO THE KINGDOM

Most studies on wealth disparity have focused on income redistribution, not expanding investor opportunities, as the basis for solutions.²⁴³ If lack of investor opportunity contributes to wealth inequality, then addressing the source of the barrier—the federal securities laws—should be part of the solution. Presently, average investors seeking steady returns, or diversification options away from public equities susceptible to market risk, lack few options other than low-performing public debt and treasury securities.²⁴⁴ This lack of options may contribute to the fact that savings rates among average Americans are in decline.²⁴⁵ Meanwhile, the significant advantages to issuers of raising capital through private offerings²⁴⁶ make new initial public offerings increasingly rare.²⁴⁷ The SEC itself conservatively estimates that at least half of the capital raised each year by businesses and investment funds comes from private

²⁴¹ THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (Harvard University Press 2014).

²⁴² See generally Sethi, *supra* note 5.

²⁴³ See, e.g., *id.* at 783-97.

²⁴⁴ See *supra* Part IV.B. This is not to say that treasury securities and bonds are useless investment instruments, rather, that by themselves they are insufficient diversification tools.

²⁴⁵ Lee, *supra* note 16, at 1008-11.

²⁴⁶ See *supra* sources cited and text accompanying notes 32-34.

²⁴⁷ See, e.g., Rodrigues, *supra* note 15, at 3407 (citing Douglas J. Leary, *M&A Landscape in 2013: Whither the Bottom?*, in *MERGERS AND ACQUISITIONS LAW 2013: TOP LAWYERS ON TRENDS AND KEY STRATEGIES FOR THE UPCOMING YEAR* 55 (2013), available at 2013 WL 574804, at *4).

placements.²⁴⁸ At the same time, less than ten percent of Americans can participate in such offerings.²⁴⁹

Disclosure is the foundation of the federal securities laws. As such, the SEC notes with particular dismay that, pursuant to their exemption from the Investment Company Act, investors have little to no information about private investment funds.²⁵⁰ Illiquidity, expensive management fees, and high levels of idiosyncratic risk contribute to the SEC's concerns about private investments.²⁵¹ These concerns are well founded. There is also no reason to dismantle the disclosure regime of the Securities Act entirely or to force all issuers to abide by the requirements of the Securities Act and the Investment Company Act. As Congress and the SEC both concede, private investment funds and private securities offerings provide numerous benefits to the financial markets.²⁵² Continued rigid adherence to the *Ralston Purina* justifications²⁵³ for keeping private offerings exclusive to the very rich is, however, not only under-inclusive of who should be able to invest,²⁵⁴ it is also grossly unfair to the middle class.

The Dodd-Frank Act requires the SEC to revisit at least the accredited investor definition with respect to individuals.²⁵⁵ Rather than further restrict who qualifies as an accredited investor—as appears to be the Congressional intent behind this mandate²⁵⁶—the SEC should instead consider the numerous existing proposals for expanding investor opportunity. The SEC should likewise consider revising the qualified purchaser definition to expand access to private funds and their significant investment advantages.

²⁴⁸ Disqualification of Bad Actors, *supra* note 34, at 44754.

²⁴⁹ *Id.*

²⁵⁰ *See, e.g.*, SEC Release 8766, *supra* note 10, at 8.

²⁵¹ *Id.*

²⁵² For instance, the SEC notes that hedge funds contribute to market efficiency, enhance overall liquidity in markets, distribute risk, absorb losses, and allow for portfolio diversification. SEC Staff Report, *supra* note 24, at 4-5. Congressional hearings on NSMIA reveal their belief that Section 3(c)(7) would encourage greater investment in emerging companies, promote the development of novel investment products, and reduce costs for institutional investors by relieving regulatory burdens. *See* NSMIA Hearings, *supra* note 71, at 4-5.

²⁵³ *Sec. and Exch. Comm'n. v. Ralston Purina Co.*, 346 U.S. 119 (1953).

²⁵⁴ *See, e.g.*, Finger, *supra* note 14, at 733.

²⁵⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, 124 Stat. 1376, § 413 (2010).

²⁵⁶ *See, e.g.*, Lee, *supra* note 16, at 990-91.

Presently, both standards rely on net worth and gross income as proxies for the *Ralston Purina* objectives of investor sophistication, access to information, and ability to bear the loss.²⁵⁷ Some commonly proposed alternatives to this rigid standard include a financial literacy test administered by the SEC,²⁵⁸ establishing public mutual funds that would invest in private securities,²⁵⁹ and allowing for sophisticated investor self-certification similar to British law.²⁶⁰ In particular, private placement mutual funds offer interesting possibilities. First, because the fund managers would make the actual investment determinations for any money committed to the funds, this alleviates concerns about the purported inability of average investors to “fend for themselves.”²⁶¹ Second, most average investors’ primary interaction with the capital markets is through their 401(k) plans (or similar tax-advantaged qualified retirement savings plans). As the tax treatment of 401(k) plans makes them inherently illiquid to begin with, the added illiquidity of including a private placement mutual fund in a 401(k) portfolio is inconsequential.²⁶²

The Government Accountability Office (GAO) recently performed its own review of the accredited investor standard and proposed that investors utilizing the services of registered investment advisers be able invest in private placements.²⁶³ Although this option avoids the rigidity of the current standards and promotes access to private offerings, only the relatively wealthy are likely able to afford registered investment advisers.²⁶⁴ In this respect, merely certifying those represented by registered investment advisers as accredited investors or qualified purchasers is an inadequate response to the inherent inequity of the present regime.

²⁵⁷ See *supra* Part II.A-B.

²⁵⁸ Oguss, *supra* note 14, at 310; Finger, *supra* note 14, at 763-66.

²⁵⁹ Rodrigues, *supra* note 15, at 3430-33.

²⁶⁰ Financial Services and Markets Act 2000 (Financial Promotion) Order, 2005, S.I. 1529, art. 50A (U.K.).

²⁶¹ Sec. and Exch. Comm’n. v. *Ralston Purina Co.*, 346 U.S. 119, 124-26 (1953).

²⁶² One of the most significant illiquidity concerns is the inability of investors to liquidate private securities to meet unexpected cash needs. See *infra* sources cited and text accompanying notes 100-06. This concern does not apply in the context of a 401(k) plan because investors cannot withdraw from a 401(k) (except in extreme cases) no matter what the underlying investment strategy of the plan.

²⁶³ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-640, ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED (2013).

²⁶⁴ See, e.g., Finger, *supra* note 14, at 733.

The recent proposed regulations for the new Securities Act section 4(a)(6) exemption for crowdfunding may provide another potential solution for private placements outside the crowdfunding context. Crowdfunding effectively allows average investors, informed by the “wisdom of the crowd,” to make a form of angel investment in a newly formed enterprise using a funding portal.²⁶⁵ Crowdfunding investments are potentially even riskier than other angel investments because many of the investment opportunities are likely to be extremely speculative, “idea only”²⁶⁶ enterprises with limited business plans.²⁶⁷

To counter these risks while preserving the advantages of avoiding registration, the proposed crowdfunding regulations implement several safeguards. The “funding portal”—an intermediary between the investor and the issuer—is required to prepare and provide to each investor educational materials about the risks of investing.²⁶⁸ These educational materials must discuss the general risks of the investments, including illiquidity, dilution, and the possibility of losing most or all of an investment.²⁶⁹ The regulations further require intermediaries to prepare and present to all investors an acknowledgement of risk.²⁷⁰ This acknowledgement would ensure that the investor understands the risks of the investment, has reviewed the relevant educational materials, and is able to bear any potential losses.²⁷¹ The proposed regulations also discuss using a questionnaire to assess investor understanding of the educational materials.²⁷² Finally, the regulations impose an annual investment limit tied to annual income.²⁷³

Although the broader context of crowdfunding is extremely different from private investment funds, many of the safeguards proposed in the crowdfunding context may also be suitable in the private placement context. For instance, average investors could invest in private investment funds subject to a total annual

²⁶⁵ Jumpstart Our Business Startups Act, Pub L. No. 112-106, § 302, 126 Stat. 306, 315-21 (2012) (codified at 15 U.S.C. § 77d(a)(6), 15 U.S.C. § 77d-1); *see also* Crowdfunding, SEC Release No. 9470, 2013 WL 5770346 (Oct. 23, 2013) [hereinafter SEC Release 9470].

²⁶⁶ SEC Release 9470, *supra* note 265, at 26.

²⁶⁷ *Id.* at 15.

²⁶⁸ *Id.* at 68-69.

²⁶⁹ *Id.*

²⁷⁰ *Id.* at 76-78.

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ *Id.* at 9.

investment limit tiered to their level of income or net worth. The SEC could also prepare general educational materials about private investment funds and angel investments and provide them to investors. These materials could discuss, in plain English, the risks and benefits of private placements in general. So long as the SEC prepares the materials, and not broker-dealers or the funds themselves, issuers would face no additional costs or potential liabilities (preserving a major advantage of private placements). The SEC could further require that investors sign a risk acknowledgement and complete a questionnaire prior to investing. Combining some or all of these proposals is one avenue by which the securities laws could provide middle class investors access to private placements without completely undermining the disclosure regime of the Securities Act. It also frees investors to determine for themselves what level of investment risk they are willing and able to bear.

The SEC should also invest in investor education.²⁷⁴ Only a tiny fraction of Americans actually participate in the securities markets at all, much less private placements.²⁷⁵ Congress and the SEC need to ensure that all Americans understand the important role saving and investing play in generating wealth. Failure to do so will only exacerbate wealth disparity in America, regardless of whether average Americans can participate in private placements.

VI. CONCLUSION

During hearings preceding the enactment of the Investment Company Act, the Chairman of the SEC noted:

In general, everyone seems to be pretty much agreed that the functions of the investment trusts should be to afford the small investor an opportunity to spread his investment risks by a diversification of security holdings, to furnish competent and continuing investment supervision, and to assist in making capital available for industry. In a great many instances these objectives have not been realized.²⁷⁶

²⁷⁴ It has largely done so already through initiatives like Investor.gov. INVESTOR.GOV, <http://perma.cc/SYG4-YMMU> (last visited Nov. 18, 2014).

²⁷⁵ See Disqualification of Bad Actors, *supra* note 34, at 44758-59.

²⁷⁶ *Inv. Trusts and Inv. Cos.: Hearings Before a Subcomm. of the S. Comm. on Banking and Currency*, 76th Cong. 46 (1940) (statement of Judge Healy, Chairman of the Sec. and Exch. Comm'n.). 46 (1940) (statement of Judge Healy, Chairman of the Sec. and Exch. Comm'n.).

Seventy-five years later, these principles remain a dream deferred; the securities laws continue to fail the small investor. Private placements permit the wealthiest Americans to preserve and accumulate wealth while the average middle class investor falls behind. The accredited investor standard forecloses the advantages of direct investments in private companies to 90 percent of Americans. Meanwhile, the even more demanding qualified purchaser definition restricts investments in highly advantageous private investment funds—hedge funds, private equity funds, and venture capital funds—to only the wealthiest one percent. This legal regime has contributed over the past 35 years to the growing divide between the wealthiest Americans and everyone else.

Most discussions about wealth inequality focus on income redistribution as the solution. In an age where earning higher investment returns leads to greater long-term wealth, a better solution is to expand investment opportunities. As the SEC reconsiders the accredited investor standard, it should strongly consider proposals—like sophisticated investor self-certification, mutual funds for private securities, annual investment limits, and educational materials combined with risk acknowledgements—that will open the kingdom of the private placement to the average investor. The middle class American investor has been left behind for far too long. The time has come to change his fate. Let's give the average investor the keys to the kingdom.

APPENDIX A

ANNUAL RETURNS OF SELECTED ASSET CLASSES (1989-2013)

Year	S&P 500	Bonds (Barclay's Aggregate Index)	10 Year Treasury Note	Hedge Funds (Barclay's Fund of Hedge Funds Index)	Private Equity Funds (see Appendix B)	Venture Capital Funds (See Appendix C)	Inflation (Consumer Price Index)
1989	31.48	14.53	17.69				4.80
1990	-3.06	5.96	6.24				5.40
1991	30.23	16.00	15.00				4.20
1992	7.49	7.40	9.36				3.00
1993	9.97	9.75	14.21				3.00

3							
199 4	1.33	-2.92	-8.04				2.60
199 5	37.2 0	18.46	23.48				2.80
199 6	22.6 8	3.64	1.43				3.00
199 7	33.1 0	9.64	9.94	9.91	33.36	74.82	2.30
199 8	28.3 4	8.70	14.92	8.23	45.11	91.62	1.60
199 9	20.8 9	-0.82	-8.25	36.56	59.22	23.02	2.20
200 0	- 9.03	11.63	16.66	12.19	-35.38	-15.23	3.40
200 1	- 11.8 5	8.43	5.57	6.77	51.30	-15.32	2.80
200 2	- 21.9 7	10.26	15.12	1.42	-7.10	15.75	1.60
200 3	28.3 6	4.10	0.38	17.99	-5.48	-5.85	2.30
200 4	10.7 4	4.34	4.49	8.80	12.05	0.55	2.70
200 5	4.83	2.43	2.87	10.67	19.96	0.76	3.40
200 6	15.6 1	4.33	1.96	12.39	16.33	6.47	3.20
200 7	5.48	6.97	10.21	10.22	16.91	6.16	2.80
200 8	- 36.5 5	5.24	20.10	-21.63	1.22	-7.14	3.80
200 9	25.9 4	5.93	-11.12	23.74	-15.08	0.59	-0.40
201 0	14.8 2	6.54	8.46	10.88	19.69	3.91	1.60
201 1	2.10	7.84	16.04	-5.48	22.35	3.83	3.20
201 2	15.8 9	4.22	2.97	8.25	2.08	1.85	2.10
201 3	32.1 5	-2.02	-9.10	11.12	15.43	6.43	1.50

APPENDIX B:

REVERSE EXPECTATION HYPOTHESIS CALCULATION OF IMPLIED
ANNUAL RETURNS ON PRIVATE EQUITY FUNDS

Annualized returns of private equity funds and venture capital funds are inherently difficult to estimate. Private funds derive their returns from the acquisition and subsequent resale of private companies whose financial data are not public. Funds typically seek to exist their portfolio company investments on a horizon of seven to ten years. During the first years of the investment, the portfolio companies often decline in value as the fund management seeks to improve efficiencies and make capital investments that will generate long-term, rather than short-term, returns. Consequently, declining values in portfolio companies in early years of the investment cycle do not reflect the “true” economic performance of the fund. In addition, lifetime internal rates of return (“IRR”), a traditional measure of private equity performance, are often a poor measure of return on investment, at least from the standpoint of the investors. IRRs measure the total return on the acquisition and divestment of the portfolio companies to the fund itself. IRRs, however, do not reflect real economic return to the fund investors because they do not exclude the management fees and carried interest that fund managers retain.

Data provided by Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?* J. OF FIN. 33-34 (July 2013) (forthcoming) provides a partial solution. The authors use timed cash flows of approximately 1,400 funds to estimate both an IRR and a public market equivalent (“PME”) ratio. The authors suggest that PME ratios serve as the best comparison to public market returns because they focus on capital returned to investors (net of fees and carried interest). The PME ratios approximate lifetime returns of private equity funds as a multiple of an equivalent investment on the S&P 500 (a PME of 1.09 is nine percent greater than an equivalent investment on public markets). The problem with PME ratios is that they reflect lifetime excess returns by vintage year (the year a fund is established) and not on a year-by-year basis.

Some state treasuries and public pension funds release data on their private equity fund investments, and this data can help fill the gap. This analysis uses publicly available private fund performance from two sources: the California Public Employees

Retirement Service (“CalPERS”) Public Employees Retirement Fund (“PERF”), CALPERS, COMPREHENSIVE ANNUAL FINANCIAL REPORTS (2001-2014), *available at* <http://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/comprehensive-annual-financial.xml>, and the Washington State Investment Board (“WSIB”), WASHINGTON STATE INVESTMENT BOARD, PORTFOLIO OVERVIEW BY STRATEGY (2003-2014), *available at* http://www.sib.wa.gov/financial/invrep_qr.asp. Given the volume of assets under management at CalPERS and WSIB (32.27 billion and 10.85 billion, respectively, as of 2013), their annual return data should provide a decent sample of overall private equity fund performance nationwide.

To imply the annual returns on private equity funds, this analysis undertakes six steps:

- (1) Calculate a weighted average of the CalPERS and WSIB private fund returns based on assets under management.
- (2) Assuming that the weighted CalPERS and WSIB average is representative of broader U.S. private equity performance, calculate the average fund life implied by the Harris, et. al., lifetime PME ratios. The calculation results in an average fund life of seven years.
- (3) For each PME vintage year (n), determine the corresponding S&P 500 return year ($n + 7$). For that year, calculate the compounded total return on a \$1 investment on the S&P 500 after seven years (the capital returned to investors at the end of seven years).
- (4) Multiply the resulting compounded return in year ($n + 7$) by the PME ratio (which describes the excess return on private equity over the S&P 500), to give the total seven year return on \$1 invested in a private equity fund.
- (5) For years available, utilize the weighted average of the CalPERS and WSIB returns.
- (6) For the years prior to the availability of the CalPERS and WSIB data, use a reverse expectation hypothesis to imply the missing years of annual returns using the PME ratio and the weighted CalPERS and WSIB returns as constants.

Assuming a seven-year fund life, the implied annual return (r) is given by:

$$r_{(n+7)} = \frac{(S\&P\ Return_{(n+7)})(PME_{(n+7)})}{(r_{(n+6)}+1)(r_{(n+5)}+1)(r_{(n+4)}+1)(r_{(n+3)}+1)(r_{(n+2)}+1)(r_{(n+1)}+1)} - 1$$

The resulting r values for implied annual returns have a margin of error of approximately 7.94 percent.

Vintage Year (n)	Equivalent S&P Return Year ($n+7$)	PME Ratio	Total 7-Year S&P Return on \$1.00 *	Total 7-Year PE Fund Return on \$1.00 **	Cal-PERS Annual P.E. Fund Return	Cal-PERS Assets Under Management (billions)	WSIB Annual P.E. Fund Return	WSIB Assets Under Management (billions)	Weighted CalPERS and WSIB Return	Implied Annual Return (r)* **
1991	1997	1.32	3.39	4.47						33.36
1992	1998	0.89	4.48	3.99						45.11
1993	1999	1.24	4.16	5.16						59.22
1994	2000	1.75	3.52	6.17						-35.38
1995	2001	1.20	2.82	3.39	51.30	5.59			51.30	51.30
1996	2002	0.90	2.17	1.96	-7.10	6.61			-7.10	-7.10
1997	2003	1.30	2.03	2.65	-10.60	7.39	3.97	4.00	-5.48	-5.48
1998	2004	1.21	1.84	2.22	12.80	7.76	10.66	4.20	12.05	12.05
1999	2005	1.27	1.45	1.84	23.10	9.85	14.48	5.63	19.96	19.96
2000	2006	1.47	1.30	1.92	19.20	12.05	10.51	7.18	16.33	16.33
2001	2007	1.38	1.14	1.57	23.20	16.82	4.94	8.84	16.91	16.91
2002	2008	1.53	0.79	1.21	5.80	24.01	-14.07	7.18	1.22	1.22
2003	2009	1.58	1.13	1.79	-25.90	21.79	8.72	8.98	-15.80	-15.80
2004	2010	1.51	1.67	2.52	23.90	28.70	7.90	10.23	19.69	19.69
2005	2011	1.23	1.20	1.47	28.30	34.40	2.61	10.38	22.35	22.35
2006	2012	0.99	1.32	1.31	1.00	34.18	5.65	10.38	2.08	2.08
2007	2013	1.02	1.51	1.54	18.20	32.27	7.18	10.85	15.43	15.43

* Invested in year n and compounded using Appendix A data to reach year ($n+7$)

** S&P seven-year return x PME ratio

*** For 2001-2013, r reflects the weighted CalPERS and WSIB return; for 1997-2000, r reflects the reverse expectation hypothesis formula to imply annual returns.

APPENDIX C:

REVERSE EXPECTATION HYPOTHESIS CALCULATION OF IMPLIED ANNUAL RETURNS ON VENTURE CAPITAL FUNDS

Like private equity fund returns, returns on venture capital funds are difficult to estimate. This analysis uses a process similar to that for private equity funds (found in Appendix B) to imply the average annual returns on venture capital funds. There are two important differences between the process used for private equity funds and that used for venture capital funds:

- (1) CalPERS returns are not available for venture capital funds as a distinct group from private equity. Therefore, the venture capital fund calculation uses only the WSIB returns and not a weighted average of both CalPERS and WSIB returns.
- (2) The average fund life for venture capital funds implied by the Harris, et. al, PME ratios is only six years as opposed to seven years for private equity funds.

Assuming an average fund life of six years, the implied annual return (r) is given by

$$r_{\text{implied}} = \frac{(S\&P \text{ Return}_{(n+n)})^{(PME_{(n+n)})}}{(r_{(n+2)}+1)(r_{(n+4)}+1)(r_{(n+6)}+1)(r_{(n+8)}+1)(r_{(n+10)}+1)(r_{(n+12)}+1)} - 1$$

The resulting r values for implied annual returns have a margin of error of approximately 0.96 percent.

Vintage Year (n)	Equivalent S&P Return Year ($n + 6$)	PME Ratio	Total 6-Year S&P 500 Return on \$1.00*	Total 6-Year VC Fund Return on \$1.00**	Implied Annual Return (r)*
1992	1997	1.34	2.68	3.60	74.82
1993	1998	2.74	3.20	8.78	91.62
1994	1999	2.86	3.52	10.07	23.02
1995	2000	2.09	3.16	6.61	-15.23
1996	2001	4.17	2.03	8.47	-15.32
1997	2002	2.65	1.29	3.42	15.72
1998	2003	1.48	1.25	1.84	-5.85
1999	2004	0.90	1.08	0.97	0.55
2000	2005	0.85	0.93	0.79	0.76

2001	2006	0.84	1.19	1.00	6.47
2002	2007	0.88	1.42	1.25	6.16
2003	2008	0.99	1.15	1.14	-7.14
2004	2009	0.96	1.13	1.09	0.59
2005	2010	1.23	1.17	1.44	3.91
2006	2011	0.97	1.14	1.11	3.83
2007	2012	0.99	1.15	1.13	1.85
2008	2013	0.84	1.43	1.21	6.43

* Invested in year n and compounded using Appendix A data to reach year $(n + 6)$

** S&P six-year return x PME ratio

*** For 2003-2013, r reflects the WSIB return; for 1997-2003, r reflects the reverse expectation hypothesis formula to impute annual returns.